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Focus on Intercompany Transfer Price and Other Income Tax Insights

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Willamette Management Associates
Thought Leadership

Insights

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Focus on Intercompany Transfer Price and Other Income Tax Insights
Editor for This Issue: John C. Ramirez

Intercompany Transfer Price Insights

Thought Leadership:
Transfer Pricing Audits under the New IRS Roadmap and Disputing Proposed Adjustments 3
Robert C. Morris, Esq., and Richard L. Hunn, Esq.

Advance Pricing Agreements: The What, Why, and How from the Valuation Analyst Perspective 13
Justin M. Nielsen

Important Considerations in the Pricing of Intercompany Loans and Financial Guarantees 19
Matt C. Courtnage

The Impact of the Standard of Value on Transfer Pricing and Financial Accounting in the United States. .28
Stephen P. Halligan

Judicial Decision Insights

The Scrutiny of Executive Compensation. 36
Irina V. Borushko and Lisa H. Tran

A Review of BMC Software, Inc. v. Commissioner of Internal Revenue: Should Intercompany Accounts Receivable Be Considered "Debt"? 47
Samuel S. Nicholls

Intangible Property Transfer Price Insights

Intangible Property in Transfer Pricing Analyses. 56
Aaron M. Rotkowski

Best Practices:
The Valuation of Trademark-Related Intangible Property 66
John E. Elmore, JD, CPA

Estimating Intercompany Transfer Price Trademark Royalty Rates 81
John C. Ramirez

Forensic Analysis Insights

Structuring the Intangible Property Forensic Analysis Assignment 88
Robert F. Reilly, CPA

Willamette Management Associates Insights

On Our Website 95
Communiqué 96

2014 Recipient of the Apex Award

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Forethoughts

This *Insights* issue focuses on financial, economic, legal, and valuation issues that may be encountered by valuation analysts and income tax practitioners specializing in intercompany transfer pricing analyses. Transfer pricing can be an effective part of corporate tax planning. Transfer pricing and related income tax services are increasingly important to corporate taxpayers. Recently, the Internal Revenue Service and other taxing authorities worldwide have increased their scrutiny of transfer price arrangements in their search for revenue.

This *Insights* issue presents discussions on numerous topics related to transfer pricing and related income tax matters. These discussions include an overview of the current status of intangible asset transfer pricing policy in the United States and abroad, the role that valuation analysts play in the development of advance pricing agreements, recent judicial decisions involving income taxation, and an in-depth focus on intangible asset analyses performed for transfer pricing purposes.

This *Insights* issue presents two discussions of recent judicial decisions involving various taxpayer income tax matters. One of these discussions summarizes federal statutes and recent judicial decisions regarding the reasonableness of taxpayer executive compensation for income tax purposes. The other discussion presents a review of a Tax Court decision involving the definition of "debt" as it relates to intercompany indebtedness between a U.S. taxpayer and its foreign subsidiary.

And, this *Insights* issue presents several discussions focused on the identification and valuation of intangible property for transfer pricing purposes. These discussions provide guidance for the identification of intangible property and describe the generally accepted intangible property transfer price approaches, methods, and procedures used to estimate the arm's-length price of intangible property transferred between related parties. Finally, these discussions illustrate several trademark-related intangible property valuations.

Willamette Management Associates analysts are often called on to perform valuations of intangible property for various transaction, accounting, litigation, and taxation purposes. Our analysts work closely with clients to conduct analyses and prepare work products that are consistent with the client's tax and legal strategies. And, our analysts regularly assist taxpayer clients and their legal counsel with estimating the arm's length price of intangible property for transfer pricing purposes.

About the Editor

John C. Ramirez

John C. Ramirez is a senior associate in the Willamette Management Associates Portland, Oregon, office.

John specializes in the valuation, damages analysis, and transfer price analysis of intangible assets and intellectual property.

John has more than a decade of experience providing valuation and financial advisory services. These services include valuation and economic analyses for purposes of forensic analysis and dispute resolution, income tax planning and compliance, property tax compliance, estate and gift and generation-skipping tax planning, bankruptcy, shareholder oppression and dissenting shareholder appraisal rights claims, transfer pricing, transaction opinions, commercial damages disputes, and bankruptcy and reorganization.

John's practice is focused on performing business valuation and forensic analysis services for dispute resolution and litigation support purposes, including disputes related to intercompany transfer pricing, bankruptcy, and economic damages issues.

Recently, John completed the following types of analyses: (1) trademark intercompany transfer pricing analyses for two U.S. publicly traded multinational companies, (2) solvency analyses involving a 250-store retail grocery company and a privately owned, members-only ski resort in Montana, and (3) commercial litigation damages analyses involving the purchase of a multibillion dollar oil and gas storage facility in Texas and a fly-fishing fly manufacture with operations in Oregon and the Philippines.

John recently coauthored an article that appeared in the professional journal *Valuation Strategies*. John's article was entitled "Acquisitions: Seller Representations in Acquisition Agreements."

John received a bachelor of science degree in finance from the Portland State University School of Business Administration cum laude. John earned the accredited senior appraiser credential from the American Society of Appraisers. He is accredited in business valuation. John is a candidate for the chartered financial analyst (CFA) credential from the CFA Institute.

John is a member of the American Society of Appraisers (Portland chapter) and the American Bankruptcy Institute.

Thought Leadership

Transfer Pricing Audits under the New IRS Roadmap and Disputing Proposed Adjustments

Robert C. Morris, Esq., and Richard L. Hunn, Esq.

Transfer prices can be an effective part of corporate tax planning for multinational taxpayers. Legal counsel and their economic advisers should be aware of the Service's current approach to transfer pricing audits and of the avenues for disputing any proposed transfer price adjustments.

Introduction

Multinational businesses today face unprecedented taxation challenges as governments around the world become increasingly aggressive in their search for revenue.

These enhanced taxation enforcement efforts, together with an increased level of cooperation among government tax agencies, present extraordinary income tax compliance challenges for multination companies.

Due to its inherent subjectivity and potential for abuse, the transfer pricing of intercompany transactions continues to receive intense scrutiny by national tax authorities. The Internal Revenue Service ("Service") recently made ambitious changes in its approach to these examinations, and taxpayers are feeling the effects of those changes.

First, this discussion describes the Service's current approach with respect to transfer pricing examinations.

Second, this discussion highlights some practical considerations at different decision points of the examination.

Finally, this discussion explores some of the avenues for the disputing of—and for the seeking relief from—any transfer pricing adjustments proposed by the Service team.

Brief Background on Transfer Pricing and Why It Matters for Income Tax Purposes

Transfer pricing generally refers to the setting of prices for cross-border transactions (generally involving goods, services, or intangible property) between related companies. For example, if Affiliate A manufactures widgets in Country X and sells those widgets to Affiliate B in Country Y, the price that Affiliate A charges Affiliate B for those widgets is the transfer price of those widgets.

Other common examples of transfer pricing transactions include cross-border intercompany loans and leases of either tangible or intangible property. The interest rates charged for the loans and the royalty/rental rates charged for the use of property is the transfer price of those items.

The reason for the Service and other national taxing authorities' intense focus on transfer pricing may be easily illustrated by returning to our first example.

If Country X (where the widgets are manufactured) has a lower tax rate than Country Y (where the widgets are ultimately sold to unrelated parties), then there may be an economic incentive for the consolidated company to maximize the amount of the taxable income from the widget sales in Country X and minimize the taxable income in Country Y.

One way to accomplish this objective is to set the transfer price of the widgets from Affiliate A to Affiliate B at a relatively high sales price so that Affiliate B's profit (sales price minus purchase price) from the sale of the widgets is minimized in Country Y.

National taxing authorities are well aware of strategies that shift income from one country to another, and thus require that transfer prices be set at arm's length.

The Service May Determine a Taxpayer's "True Taxable Income"

Internal Revenue Code Section 482[1] allows the Service to reallocate items of income and expense among controlled taxpayers to clearly reflect income. The essence of Section 482 is to place "a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining the true taxable income of the controlled taxpayer."[2]

A controlled taxpayer's "true taxable income" is determined as though the taxpayer had dealt "at arm's length" with an uncontrolled taxpayer.[3]

This analysis is inherently subjective, however, because oftentimes affiliates may not sell their goods or services to unrelated parties. Therefore, there may be no uncontrolled transaction for the taxpayer and the Service to use as a benchmark.

The Service's Sea Change Approach to Transfer Pricing Audits

In late 2010, the Service announced the creation of a "Transfer Pricing Practice" staffed by the "most experienced transfer pricing examiners and economists."[4]

As stated by the first director of the Transfer Pricing Practice, "[t]he No. 1 target . . . is the need to develop the important cases and develop them well. Nothing changes taxpayer behavior more than a winning IRS position."[5]

The Service Releases Transfer Pricing Audit Roadmap

To that end, in 2014 the Service released a "Transfer Pricing Audit Roadmap" (the "roadmap") and a September 30, 2013, memorandum setting forth the "IBC – TPP Rules of Engagement."

The roadmap is a "work in process" and "provide[s] the transfer pricing practitioner . . . with audit techniques and tools to assist with the planning, execution and resolution of transfer pricing examinations."[6]

The roadmap emphasizes "up-front planning . . . at the earliest possible stage" and divides a 24-month audit cycle into three stages: planning, execution, and resolution. The roadmap bears striking similarities to a litigator's trial plan and calls for the early development of a "working hypothesis" (which may be adjusted) and robust factual development.

The roadmap goes so far as to instruct which examination team members should be involved in each stage and discussion. Not surprisingly, the roadmap provides the most guidance and details on the planning and factual development on an issue.

Until recently, it was unclear to many practitioners and taxpayers as to who on the Service examination team was in control of the transfer pricing audit.

The "IBC – TPP Rules of Engagement" memorandum, addressed to Service employees in the Internal Business Compliance unit and Transfer Pricing Practice, attempts to clear up this issue by stating that neither group has "control" of transfer pricing issues and that the Service should "work transfer pricing issues together, as a unified team."

This can be frustrating in practice, as the local economist assigned to the Service examination team may not see eye-to-eye with those in the Transfer Pricing Practice.

The roles and level of engagement of the Transfer Pricing Practice team members varies from case to case, and is "flexible and dynamic to adjust to the circumstances of the audit, which may change over time." This level of involvement ranges from "limited" to "moderate" to "extensive."

The memorandum explains that "in many or even most cases, the TPP, as a result of its limited resources, will have no involvement in the day-to-day management of the issue. However, the IBC and TPP management teams have joint responsibility for the national transfer pricing inventory."

The Service audit plan provided to taxpayers towards the beginning of an audit typically identifies the members of the examination team, so taxpayers should be able to determine early on whether the Transfer Pricing Practice is involved and plan accordingly. The authors experience is that the Service is quite open about the level of involvement of the Transfer Pricing Practice.

Pre-Examination/Planning Stage

This first stage of the transfer pricing audit consists of the initial risk assessments and may last more than six months and include time before the 24-month audit cycle begins. During this stage, the Service examination team reviews the taxpayer's returns for controlled transactions and disclosure of uncertain tax positions.

The examination team also reviews publicly available information (such as SEC filings) to learn more about the company's background and business operations, and to compute financial ratios for the company. Looking forward to a potential dispute, the roadmap notes that the information gathered during this stage "will become part of the 'Background' section of any transfer pricing NOPA [Notice of Proposed Adjustment] and the related economist report."

Examination teams are also instructed to request a company's transfer pricing report with the initial examination contact letter, and taxpayers should stay mindful that the tax law requires that the transfer pricing report be provided to the Service within 30 days of the request, in order to avoid the application of certain accuracy-related penalties.[7]

Taxpayers should also be prepared to make a detailed presentation of their transfer pricing to the Service early on in the examination (this presentation is referred to in the roadmap as the "transfer pricing orientation meeting"). One decision that taxpayers should make early on is who is the best person to lead this required presentation to the Service.

Options include in-house personnel, the preparer of the transfer pricing reports, and the company's tax counsel. There are advantages and disadvantages to each, and companies should carefully consider options with their counsel.

Taxpayers should not approach this presentation haphazardly, as it may affect the entire trajectory of the examination. This is because the Service examination teams are instructed to hold a reassessment meeting after this orientation to determine which transactions need further development and which can be eliminated from further analysis. Taxpayers may approach this meeting as their last shot to convince the Service not to continue its audit.

Taxpayers and their advisers must also pay close attention to any facts or representations made verbally and/or on the slides presented during the orientation meeting. The safest approach is to assume those slides and/or statements will be used as an exhibit by the examination team in a later dispute.

The authors recently attended an orientation meeting where the taxpayer was asked to discuss, among other things, "all intercompany transactions in the years under the exam," "the transfer methods reported on the tax return and an explanation of why the method was chosen," and the "functions performed, assets employed and risks assumed by each controlled party to the respective intercompany transaction."

The presentation was attended in-person by approximately 10 Service employees who took copious notes and were active participants during the presentation. The examination team followed up the meeting by issuing a number of additional requests for information related to the topics covered during the presentation (often quoting the slides and the taxpayer's verbal responses to questions asked by the Service during the presentation).

Taxpayers who continue to receive questions about their transfer pricing after this orientation meeting should be wary that the examination team's working hypothesis may be that the taxpayer's transfer pricing is not arm's length (especially if those questions come from the Transfer Pricing Practice team members).

The last step of the planning phase includes completing the audit plan and risk analysis, and then sharing both with the taxpayer after the examination team receives managerial approvals.

Execution Phase

The execution phase of a transfer pricing audit lasts approximately 14 months and is comprised of the following two stages:

1. Fact finding
2. Issue development

The roadmap notes that "[t]ransfer pricing cases are usually won and lost on the facts. The key in transfer pricing cases is to put together a compelling story of what drives the taxpayer's financial success, based on a thorough analysis of functions, assets, and risks, and an accurate understanding of the relevant financial information."

Taxpayers should expect to receive requests for additional documents, to interview taxpayer personnel, and receive tours of the taxpayer's facilities. The authors' recent experience is that the examination teams are focusing on the audited financial statements of foreign affiliates and organizational charts with the names of individuals rather than just the individual's job title. The Service will often request to interview those individuals.

The entire examination team also performs a comparability and functional analysis during this stage. The functional analysis "is a critical aspect of any transfer pricing examination" that "identifies the economically significant activities performed in connection with the transaction." Economically significant activities are those that materially affect the prices charged and profits earned from a transaction.

The examination team also requests that the taxpayer confirm (in writing) the material facts developed during the audit or explain why the examination team's version of the facts are inaccurate, aiming for "an agreed set of facts."

Again, taxpayers and their advisers should be careful that any facts agreed to are accurate, as the Service notes "[t]ransfer pricing cases are usually won and lost on the facts."

The Service examination team then completes its draft of the background and factual write-up to be used in the draft NOPA and draft economist report. The draft NOPA and draft economist report are shared with the taxpayer for input.

Issue Resolution

After meeting with the taxpayer and considering any input provided by the taxpayer, the examination team issues an NOPA setting forth the examination team's proposed adjustments.

The receipt of an NOPA is a major decision point for taxpayers in a transfer pricing exam. One decision is whether the taxpayer should request assistance from the U.S. competent authority.[8]

If the adjustments in the NOPA are ultimately sustained, the taxpayer may be subject to double taxation of the same income by the United States and a foreign country.

Going back to the widget example, if Affiliate A reported a transfer price of 10 in Country X on the widget sales, but Country Y determines that the transfer price should have been 8, then the "extra" 2 may be subject to tax in both Countries X and Y.

If the United States has a tax treaty with the other country that could be affected by the proposed adjustment, the taxpayer may request that the U.S. competent authority assist in eliminating that double taxation.[9]

The international examiner is required to notify the taxpayer by letter of the potential double taxation and the taxpayer's right to request competent authority assistance.[10]

Double Taxation, Competent Authority Assistance, and Advance Pricing Agreements

The purpose for requesting competent authority assistance is for the U.S. competent authority to consult with the treaty country's competent authority to reach an agreed upon resolution of adjustments by either country that would be contrary to the provisions of the treaty, such as double taxation. The procedure whereby the competent authorities consult with each other pursuant to provisions of the treaty is commonly referred to as the mutual agreement procedure, or "MAP."[11]

If the United States accepts a request for assistance, it generally will consult with the foreign competent authority and attempt to reach a mutual agreement that is acceptable to all parties.[12]

In the context of a U.S.-initiated transfer pricing adjustment, the U.S. competent authority's primary goal typically is to obtain a correlative adjustment from the treaty country.[13]

There are some risks for taxpayers who choose to bypass competent authority assistance. For example, if a taxpayer enters into a binding settlement with the Service appeals division, the U.S. competent authority will limit its assistance to attempting to obtain a correlative adjustment from the treaty country.[14] This may not eliminate double taxation.

Another option for taxpayers is to request simultaneous consideration by Service Office of Appeals ("Appeals") and the U.S. competent authority under the Simultaneous Appeals procedure.[15]

Taxpayers currently may request the Simultaneous Appeals procedure when:

1. an NOPA is issued and it requests U.S. competent authority assistance,

2. the taxpayer files a protest and decides to sever the competent authority issue and seek competent authority assistance while other issues are referred to Appeals, or
3. the case is already in Appeals and the taxpayer decides to request competent authority assistance.

Additionally, a taxpayer may request the Simultaneous Appeals procedure after a case is under consideration by the competent authority. If, however, the competent authority has already provided the U.S. position paper to the foreign competent authority, the request generally will be denied.[16]

If the taxpayer has requested the Simultaneous Appeals procedure, the appeals officer will consult with the taxpayer and the U.S. competent authority in an attempt to reach a tentative agreed resolution of the issues. If a tentative resolution is reached, the U.S. competent authority would then present it to the foreign competent authority in an effort to reach an agreed resolution with the foreign competent authority.[17]

If the competent authorities fail to agree, or if the agreement is not acceptable to the taxpayer, the taxpayer may withdraw its request for competent authority assistance. The taxpayer may then pursue all rights otherwise available to it under the laws of each country.[18]

Taxpayers should consult with their tax counsel before rejecting a proposed resolution reached between competent authorities.

Advance pricing agreements (APA) have also been used to minimize disputes with the Service. An APA is an agreement between the taxpayer and a taxing authority setting forth the transfer pricing of intercompany transactions.

Although the word “advance” indicates the agreement is for future years, they may include a “roll back” for the years under examination. Some taxpayers seek APAs offensively when they believe the examination team may propose an adjustment and that a better result may be obtained through an APA.

This strategy is debatable, because the examination team may be part of the APA process and the transfer pricing director should be working closely with the APA director. The authors are aware of instances where this strategy did not work as intended.

Moreover, if the taxpayer attempts to secure an APA and fails, the Service examination team may feel emboldened and Appeals may not want to compromise on an issue that the APA team has considered. APAs also generally take a long time to secure.

Having said all that, sometimes APAs are the way to go. The authors have assisted taxpayers with obtaining APAs, and the decision to request an APA and the timing of doing so should be discussed with tax counsel.

The Service, in Notice 2013-78, has proposed a new revenue procedure for requesting competent authority assistance that would update and supersede the existing revenue procedure, Revenue Procedure 2006-54. The proposed revenue procedure is lengthy and proposes numerous substantial changes. Because it is in proposed form, this discussion will not describe it in detail, but this discussion will make a few observations about the more significant changes.

The proposed revenue procedure would reflect structural changes that were implemented at the Service subsequent to Revenue Procedure 2006-54, including the establishment of the Large Business and International (LBI) division. The LBI division currently includes the office of the U.S. competent authority and separate offices under the U.S. competent authority that handle different types of requests for assistance.

Regarding requests for competent authority assistance, the proposed revenue procedure includes a number of significant changes. The proposed revenue procedure clarifies that issues that may be considered may arise as a result of taxpayer-initiated positions.[19]

The proposed revenue procedure also clarifies that the U.S. competent authority is available for informal consultations on competent authority-related issues. Such informal consultations can include whether a MAP issue may exist. It also can include advice about steps to take to achieve greater certainty that the taxpayer has exhausted all effective and practical remedies to reduce its income tax liability under foreign law for purposes of qualifying for the foreign tax credit. Such informal advice would be advisory in nature and not binding on the Service.[20]

The proposed revenue procedure also adds that the U.S. competent authority can initiate a MAP case in the absence of a MAP request, or it can expand the scope of an existing MAP case. This can include adding treaty countries, issues, or taxable years. The proffered reason for this is that the U.S. competent authority has a strong interest in resolving all potential MAP issues in a timely manner.[21]

The proposed revenue procedure also elaborates on the potential interaction of requests for competent authority assistance with advance pricing agreements. The U.S. competent authority’s goal is

"... taxpayers and their advisers should discuss the pros and cons of fast track before the NOPA is issued, as the time to make a decision is often short."

to seek MAP resolutions and APAs that achieve substantive and procedural consistency.[22]

The proposed revenue procedure would also provide new pre-filing agreement procedures applicable to MAP cases. This would include mandatory submission of a pre-filing memorandum and participation in a pre-filing conference in certain cases. The pre-filing memorandum would be required in cases raising certain issues.

The list of issues is fairly lengthy, but includes taxpayer-initiated positions, the licensing or other transfer of intangible property in connection with an intangible development arrangement, and any arrangement that qualifies as a "global trading arrangement."

Additionally, in cases where it is not mandatory, a taxpayer may submit a pre-filing memorandum and request a pre-filing conference.[23]

The proposed revenue procedure also establishes the Simultaneous Appeals procedure as the primary means of obtaining Appeals involvement in a competent authority matter. It would be the only procedure by which a taxpayer could present a U.S.-initiated adjustment to Appeals for its review and still retain the possibility of obtaining the U.S. competent authority's help in securing a correlative adjustment.

The proposed revenue procedure places strict time limits on requesting the Simultaneous Appeals procedure, which is 60 days from when the U.S. competent authority notifies the taxpayer that its request for assistance has been accepted.[24]

Fast Track Settlement

Another decision upon receipt of an NOPA is whether a taxpayer should request to participate in the "Fast Track Settlement" program ("fast track").[25]

Fast track is an optional mediation program in which an Appeals officer serves as a mediator between the examination team and the taxpayer.

Because fast track is not available after a taxpayer has requested U.S. competent authority assistance, taxpayers and their advisers should discuss the pros and cons of fast track before the NOPA is issued, as the time to make a decision is often short.

Both parties (examination team and taxpayer) must agree to utilize fast track, meaning that the examination team can decline to participate. If the examination team and taxpayer agree to fast track, the parties submit an application, together with the NOPA and the taxpayer's written response to the NOPA, to Appeals. If Appeals accepts the case, the aim of the program is to resolve the dispute within 120 days.

During fast track, an appeals team case leader (or an appeals officer supervised by an appeals team manager) trained in mediation techniques serves as a mediator. Both the taxpayer and examination team present their case to Appeals, and the Appeals mediator can propose settlement terms, which the parties can accept or reject.

The proceeding usually includes breakout sessions, and both the taxpayer and the Service examination team must have someone with decision-making authority at the session.

One of the main issues for taxpayers to consider before entering fast track is the willingness of the examination team to mediate and settle the issue. For fast track to be successful, all three participants—the taxpayer, the examination team, and Appeals—must agree to the settlement.

If the examination team's position is immovable for whatever reason, then it may be futile to participate in fast track. Also, the authors' experience is that the Apeals mediator may not view his or her role as strictly a mediator. We have participated in fast track conferences where the Appeals mediator wanted different settlement terms from those for which the examination team had agreed.

If fast track is successful, the settlement is recorded in a "Fast Track Session Report" signed by both parties and the Appeals mediator. Afterwards, the Appeals mediator will prepare formal settlement documents. If fast track is not successful, the taxpayer still retains all of its otherwise applicable appeal rights, including the right to a traditional conference before Appeals.

Traditional Appeals Hearing

If the dispute is not resolved after the NOPA is issued or at fast track, the examination team issues the taxpayer a revenue agent's report (commonly referred to as a "30-day letter"). The 30-day letter starts the clock for the taxpayer to file a formal protest with Appeals. The examination team typically reviews the protest and prepares a rebuttal.[26]

The taxpayer may request that the case be assigned to an Appeals office in a particular part of

the country, and that the hearing be held there.[27] Appeals will usually grant such a request, but it is not required to, and sometimes does not, depending on caseloads in the various Service offices.

In cases with significant international issues like transfer pricing, Appeals will usually assign the case to an appeals officer who has substantial experience with international issues, and the conference may involve a team of appeals officers.

The authors' experience is that it typically takes longer than a year for complex cases, such as a transfer pricing case, to be resolved in Appeals.

In July of 2013, Appeals began implementing the "Appeals Judicial Approach and Culture" (AJAC). This has involved significant changes in Appeals' policies and procedures, which are designed to promote a quasi-judicial approach to the way that Appeals conducts business.

Under these new policies and procedures, Appeals will generally not send a case back to the examination team for further development, and instead, the appeals officer will attempt to resolve the issues based on the information available in the file.[28]

Under AJAC, Appeals will also not raise new issues.[29] A taxpayer may raise new issues or provide new information or evidence, but if it does, Appeals will typically send the case back to the examination team for additional analysis or investigation before Appeals will consider the new issue or evidence.[30]

This new policy may deter taxpayers from holding back important pieces of evidence until the case is in before Appeals, because the case will take longer if it is sent back to the Service examination team.

Appeals now requires that there be at least 365 days remaining on the statute of limitations before accepting a case (this is a change from the prior policy of 180 days). The statute extension needs to be secured with the examination team if a taxpayer wishes to proceed to Appeals at the conclusion of the examination.

Bypassing Appeals Division

Sometimes taxpayers will choose to completely bypass Appeals consideration. One of the reasons for doing so is the delay in closing the administrative consideration of the case. Going to Appeals may take years, and some taxpayers do not wish to keep the statute of limitations on assessment open for that long.

Another potential reason to bypass is if the taxpayer does not believe it is likely that Appeals will settle the case. If the taxpayer has an issue that the Service has taken a hard-line approach on, and the taxpayer doesn't believe it can settle, going to Appeals may just delay the inevitable trial of the issue.

". . . it typically takes longer than a year for complex cases, such as a transfer pricing case, to be resolved in Appeals."

Ultimately, the appeals officer will hold a conference with the taxpayer. The taxpayer may offer to hold the conference at its representative's office. This often benefits the taxpayer in terms of planning and preparation for the meeting, logistics, and handling contingencies. It also provides the taxpayer some level of comfort in holding the meeting in a friendly environment.

The appeals conference typically begins with a preconference meeting that includes the appeals officer, examination team, and taxpayer. This gives the appeals officer a chance to ask the examination team questions about the case and provides the examination team an opportunity to state their views.[31]

Some appeals officers expect the taxpayer to comment during the preconference meeting, while others do not. The authors typically try to avoid engaging in unsolicited back and forth debate during the preconference.

Taxpayers will also need to determine who should attend the appeals conference. Transfer pricing cases are often complex, and taxpayer personnel and their economists' technical knowledge and expertise may be necessary for the conference.

At some point, the appeals officer should reach the point where they can discuss potential settlement terms with the taxpayer. This could happen as early as the first appeals conference, or it could happen after post-conference follow-up communications with the appeals officer, providing additional information or a supplemental written response regarding a particular argument or issue.

If the taxpayer and the appeals officer settle the dispute, the appeals officer will prepare settlement documents.

If no settlement is reached, the taxpayer may await a notice of deficiency and then file a petition with the U.S. Tax Court to fight the purported deficiency without first paying it. Or, the taxpayer may pay the purported tax due, file a claim for refund, and possibly litigate in the U.S. District Court or U.S. Court of Federal Claims.

There are a number of issues that taxpayers should discuss with their tax counsel before selecting a forum to litigate the tax dispute. However, if the taxpayer cannot afford to pay the purported deficiency, then the decision is made, as the U.S. Tax Court is the only forum where the taxpayer can litigate the dispute without first paying.

Conclusion

Multinational corporations are facing unprecedented challenges as governments around the world aggressively increase their search for revenue. These enhanced enforcement efforts, together with an increased cooperation among government tax agencies, present extraordinary income tax compliance challenges for multinational companies.

Despite these challenges, transfer pricing can be an effective part of corporate tax planning. Practitioners and their economic advisers should be aware of the Service's current approach to transfer pricing audits and the avenues for disputing any proposed transfer price adjustments.

This discussion focused on the Service's current approach to transfer pricing examinations, and highlights some practical considerations at different decision points of the examination. This discussion then explored some of the avenues for disputing any Service-proposed transfer pricing adjustments.

Notes:

1. All "Section" references in this article are to the Internal Revenue Code of 1986, as amended, unless otherwise indicated.
2. Treas. Reg. § 1.482-1(a)(1).
3. Treas. Reg. § 1.482-1(b)(1).
4. IR-2010-122, December 9, 2010.
5. 199 DTR G-11, October 14, 2011.
6. Both are available on the Service website.
7. Treas. Reg. § 1.6662-6(d)(2)(iii).
8. If the taxpayer requests U.S. competent authority assistance before the examination team has proposed adjustments in writing (e.g., in an NOPA), the U.S. competent authority generally will deny the request as premature. Rev. Proc. 2006-54, § 9.01.
9. The procedures for requesting U.S. competent authority assistance are set forth in Rev. Proc. 2006-54, 2006-2 C.B. 1035 (2006). The Service, in Notice 2013-78, has informed taxpayers that it intends to issue a new revenue procedure prescribing how to request competent authority assistance. That revenue procedure has not been issued as of the date this article was prepared.
10. Revenue Procedure 2006-54; I.R.M. § 4.60.2.1; roadmap, p. 23. The international examiner is also required to prepare a report (a "Mutual Agreement Procedure" report or "MAP report") in all cases involving potential double taxation, regardless of whether the taxpayer has requested competent authority assistance. The MAP report accompanies the examination report. If the taxpayer makes a request for competent authority assistance, the MAP report is provided to the U.S. competent authority, and the U.S. competent authority will typically rely on the MAP report in order to develop a negotiating position on the issue. I.R.M. § 4.60.2.4.
11. Rev. Proc. 2006-54, §§ 1.02, 2.01, 2.03.
12. Rev. Proc. 2006-54, § 2.03.
13. Rev. Proc. 2006-54, § 12.07.
14. Rev. Proc. 2006-54, § 7.05.
15. Rev. Proc. 2006-54, § 7.02.
16. Rev. Proc. 2006-54, § 8.02.
17. Rev. Proc. 2006-54, § 8.05.
18. Rev. Proc. 2006-54, § 12.05.
19. Prop. Rev. Proc. § 2.02.
20. Prop. Rev. Proc. § 2.05, 2.06.
21. Prop. Rev. Proc. § 2.08.
22. Prop. Rev. Proc. § 2.10.
23. Prop. Rev. Proc. § 3.02.
24. Prop. Rev. Proc. § 8.
25. The Fast Track Settlement Program is jointly administered by LBI and Appeals, under Revenue Procedure 2003-40, 2003-1 C.B. 1044 (2003).
26. The examination team must provide a copy of the rebuttal to the taxpayer at the time that the case is forwarded to Appeals. See Rev. Proc. 2012-18, 2012-10 I.R.B. 455 (2102), § 2.03(4)(c).
27. See Treas. Reg. § 601.106(e)(1).
28. See I.R.M. § 8.2.1.5.
29. Policy Statement 8-2; I.R.M. § 8.6.1.6.
30. See I.R.M. §§ 8.6.1.6.4, 8.6.1.6.5.
31. There are "ex-parte" rules prohibiting Appeals from discussing the case with the examination team outside the presence of the taxpayer.

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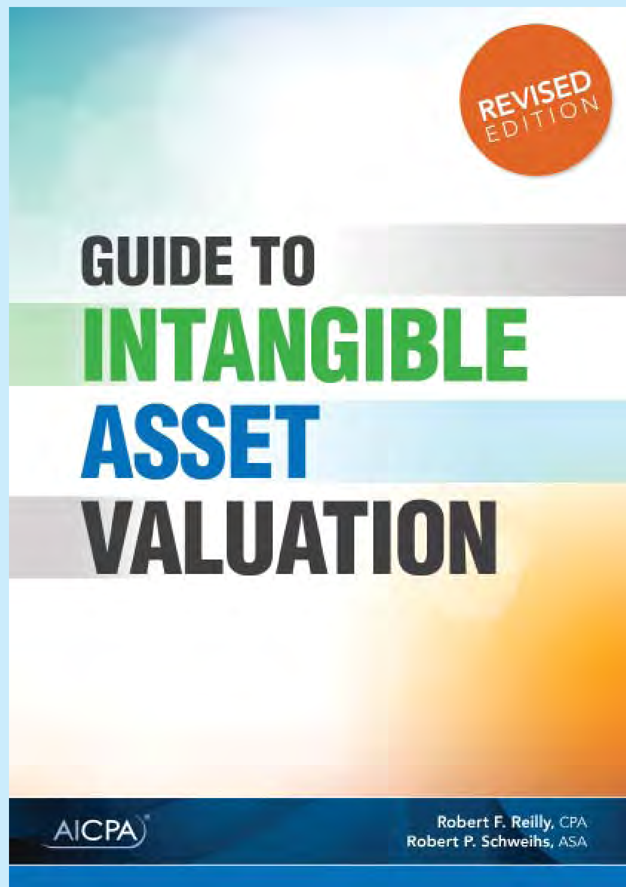
Guide to Intangible Asset Valuation

by Robert F. Reilly and Robert P. Schweihs



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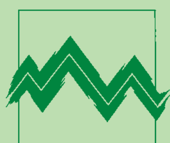

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Guide to Intangible Asset Valuation

Table of Contents

Section I Introduction to Intangible Asset Valuation

1 Identification of Intangible Assets

2 Identification of Intellectual Property Assets

3 Reasons to Conduct an Intangible Asset Valuation

4 Reasons to Conduct an Intangible Asset Damages Analysis

Section II Intangible Asset Valuation Analysis Principles

5 Intangible Asset Valuation Principles

6 Intellectual Property Valuation Principles

7 Intangible Asset Damages Principles

8 Valuation Data Gathering and Due Diligence Procedures

9 Damages Due Diligence Procedures

Section III Intangible Asset Valuation Analysis Process

10 Structuring the Intangible Asset Analysis Assignment

11 Intangible Asset Valuation Process

12 Intangible Asset Economic Damages Process

13 Highest and Best Use Analysis

Section IV Intangible Asset Valuation Approaches and Methods

14 Cost Approach Methods and Procedures

15 Cost Approach Valuation Illustrative Example

16 Market Approach Methods and Procedures

17 Market Approach Valuation Illustrative Example

18 Income Approach Methods and Procedures

19 Income Approach Valuation Illustrative Example

20 Valuation Synthesis and Conclusion

Section V Fair Value Accounting Intangible Asset Valuation Issues

21 ASC 820 and Fair Value Accounting

22 ASC 805 and Acquisition Accounting

23 Fair Value of Intangible Assets Not Acquired in a Business Combination

24 Fair Value Accounting Goodwill

Section VI Specific Intangible Asset Types

25 Intellectual Property

26 Contract Intangible Assets

27 Customer Intangible Assets

28 Data Processing Intangible Assets

29 Human Capital Intangible Assets

30 Licenses and Permits

31 Technology

32 Engineering

33 Goodwill

Section VII Reporting the Results of the Intangible Asset Analysis

34 Reporting the Results of the Intangible Asset Analysis

Bibliography

Index

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Advance Pricing Agreements: The What, Why, and How from the Valuation Analyst Perspective

Justin M. Nielsen

Intercompany transfer pricing continues to be a significant income tax issue facing multinational corporations. This has led to the increased popularity of advance pricing agreements. An advance pricing agreement (APA) is a prospective arrangement negotiated between a taxpayer and the appropriate tax authority that confirms the proper transfer pricing method used in an intercompany property or service transfer transaction. An APA can help minimize the risk of tax authority penalties related to an intercompany property or service transaction. The valuation analyst can provide significant value to a multinational taxpayer by assisting with the development and negotiation of an APA with the proper tax authority. This discussion focuses on the mechanics and recent popularity of an APA, and provides guidance as to the role the analyst can play in assisting in the APA process.

Introduction

Many multinational taxpayers find an advance pricing agreement (APA) to be a useful tool for managing multinational income tax risks. An APA is an agreement negotiated between a taxpayer and the national tax authority that details the appropriate transfer pricing method that will be used to price an intercompany transaction for income tax purposes.

Since the inception of the U.S. APA program, the use of APAs has increased in popularity. One reason for this increase in popularity is the increased scrutiny of transfer pricing (TP) and the uncertainty and scope of potential TP-related penalties levied by taxing authorities.

Taxpayer participation in the APA program is purely voluntary. An APA is a strategic tool that a taxpayer may use in order to (1) decrease the burden of tax authority compliance, (2) provide clarity as to the appropriate transfer pricing method used in a transaction, and (3) foster a cooperative relationship with the relevant tax authorities.

To that end, the valuation analyst can provide significant value by assisting the multinational taxpayer in negotiating and finalizing an APA with the appropriate tax authority.

This discussion describes the procedures associated with the formation and use of an APA. Included in this discussion are several TP- and APA-related issues that the analyst should address when assisting in the APA process. In addition, this discussion summarizes recent movements in the U.S. APA program, which is now titled the advance pricing and mutual agreement (APMA) program.

Transfer Pricing and Internal Revenue Code Section 482

Over the past few decades, intercompany transfer pricing has become a significant area of concern for businesses that are looking to expand operations internationally. This is because the Internal Revenue Service ("Service") and other taxing authorities have increased their focus on, and enforcement of, TP regulations.

Major corporations have recently been in the news as a result of TP disputes with the Service. These disputes relate to potential TP income tax

adjustments that total more than a billion dollars in certain instances. These TP disputes are one of two primary areas of international taxation where an analyst can provide guidance and assistance.

While a detailed description of the regulations and procedures associated with TP is beyond the scope of this discussion, a limited background on the mechanics of TP is relevant.[1]

A transfer price is the price charged between related parties, such as a parent company and a foreign subsidiary, in an intercompany transaction of property or services. Any intercompany transaction of economic value among related parties falls under Section 482, and includes:

1. the transfer of tangible and intangible property,
2. the transfer of intercompany services, and
3. certain intercompany cost-sharing agreements.

Internal Revenue Code Section 482 and the associated Treasury regulations govern the federal income tax aspects of TP. Section 482 is intended to prevent taxpayers from being able to allocate income, expense, or deductions between related entities in order to avoid federal income taxes.

Section 482 provides the Service with the authority to adjust taxable income between related entities to more accurately reflect the income earned by each entity.

The Section 482 standard for determining the appropriate taxable income of a controlled taxpayer (i.e., a related foreign enterprise) is the arm's-length standard. According to the arm's-length standard, the appropriate transfer price of a property or service is the price that unrelated parties would pay in a comparable transaction under comparable circumstances.

The Section 482 regulations provide specific methods for evaluating whether or not an intercompany transaction meets the arm's-length standard. The method selected and the underlying assumptions used to estimate the intercompany transfer price of an asset or service is generally one of the main areas of focus in a Service TP inquiry.

As presented in the Section 482 regulations:

> The purpose of section 482 is to ensure that taxpayers clearly reflect income attributable to controlled transactions and to prevent the avoidance of taxes with respect to such transaction. Section 482 places a controlled [affiliated] taxpayer on a tax parity with an uncontrolled taxpayer by determining the true taxable income of the controlled taxpayer.[2]

In other words, Section 482 was designed to determine the true taxable income of a controlled taxpayer by equating controlled transactions (i.e., affiliated transactions) with uncontrolled transactions (i.e., nonaffiliated transactions).

Therefore, Section 482 applies only (1) when two or more entities are under common control and (2) when the reallocation of income or deduction is necessary to reflect each entity's proper income, or to prevent an evasion of federal income tax.[3]

Treasury Regulation 482-1(i)(4) defines control as follows:

> *Controlled* includes any kind of control, direct or indirect, whether legally enforceable or not, and however exercisable or exercised, including control resulting from the actions of two or more taxpayers acting in concert or with a common goal or purpose. It is the reality of the control that is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted.

For TP purposes, common control is determined by the Service on a transactional basis, and typically the initial Service inquiry into a TP issue is whether the related entities were subject to common control.

In overseeing TP activity in the United States, the Service possesses the authority to directly adjust the allocation of the transfer price between the related entities as a result of Section 482.

The regulations state the following:

> *Authority to make allocations*. The district director may make allocations between or among the members of a controlled group if a controlled taxpayer has not reported its true taxable income. In such case, the district director may allocate income, deductions, credits, allowances, basis, or any other item or element affecting taxable income (referred to as allocations). The appropriate allocation may take the form of an increase or decrease in any relevant amount.[4]

As an aside, it would be interesting to analyze the percentage of Service allocations that result in a decrease in the price of an intercompany transaction; however, that is a topic for another discussion.

Transfer Pricing Changes Lead to Development of Advance Pricing Agreements

TP disputes between taxing authorities and taxpayers can arise from many factors. Tax-related TP disputes typically fall into three categories:

1. Tax authorities question the underlying assumptions used when a taxpayer or tax-paying entity applied a certain TP valuation method.
2. Tax authorities question the decision to select a certain TP valuation method.
3. Tax authorities disagree with the tax-paying entities' representation of the value chain within the TP group.

In the mid-1980s, and prior to the creation of the APA program, the U.S. government and certain taxpayers that were involved in transfer pricing issues began to address the possibility of an APA mechanism. In 1989, the Service collaborated with several taxpayers to negotiate and ultimately develop what were termed "advance determination rulings," the precursor to APAs.

During the 1990s, two significant changes to the legal and regulatory transfer pricing environment in the United States were implemented. The Treasury's 1993 Section 6662(e) transfer pricing penalty legislation and the Treasury's 1994 revised Section 482 regulations materially altered the transfer pricing approach of taxpayers. In conjunction, these regulatory and legal changes accomplished the following:

1. Introduced an arm's-length transfer pricing transaction range
2. Provided a transfer pricing best method rule
3. Allowed for use of inexact comparable transactions in estimating the appropriate transfer price
4. Imposed substantial monetary penalties as a result of a Service transfer pricing audit adjustment

Of the above-mentioned regulatory and legal changes, items (2) and (4) contributed substantially to the development of the APA program.

Advance Pricing Agreements

In general, an APA is an agreement between a taxpayer (i.e., multinational enterprise) and the Service that sets forth, in advance of controlled transactions (of both tangible and intangible property and service), the appropriate pricing method to be used in allocating taxable income between the related entities.

Revenue Procedure 2006-9 describes an APA as follows:

> An APA is an agreement between a taxpayer and the Service [IRS] in which the parties set forth, in advance of controlled transactions, the best transfer pricing method (TPM) within the meaning of 482 of the Code and the regulations. The agreement specifies the controlled transactions or transfers ("covered transactions"), TPM, APA term, operational and compliance provisions, appropriate adjustments, critical assumptions regarding future events, required APA records, and annual reporting responsibilities.[5]

The 1993 Section 6662(e) penalties-related legislation and regulations require taxpayers to develop adequate documentation in order to support the selection and application of the transfer pricing method (under the best method rule) and to do so prior to the filing of the tax return for the year in question.

Taxpayer reaction to the documentation requirement and the substantial penalties for filing an inappropriate transfer price resulted in the development of the APA program.

The APA Process

The goal of an APA is to enable tax authorities and taxpayers to collaborate and ultimately agree on the appropriate methods and procedures used to establish the transfer price of property and services. An APA is a legally binding agreement between the taxpayer and the Service.

An APA is not required to be inclusive of all of the taxpayer's affiliate transactions. Rather, it may be limited to specific years, specific affiliates, specific goods or services, and specific affiliate transactions.

In initiating the APA process, a taxpayer would approach the Service with a proposed APA. Alternatively, a taxpayer may request a formal prefiling conference with the Service to discuss, informally, the appropriateness of a proposed APA. The proposed APA would describe a transfer pricing method (TPM) for an affiliate transaction, along with supporting data.

In the proposed APA, the taxpayer should represent that the proposed TPM is the best method for establishing the affiliate transaction arm's-length

price. According to the Section 482 regulations, the best method is generally determined by using third-party comparable data (if available) in order to estimate an appropriate transfer price for the subject asset or service.

Upon receiving a proposed APA, the Service, through a specialized APA team, will evaluate the proposed APA by analyzing all relevant data and information that was submitted by the taxpayer in the initial request, as well as any additional subsequent data provided by the taxpayer.

There are three types of APAs: (1) unilateral APAs, (2) bilateral APAs, and (3) multilateral APAs. A bilateral or multilateral APA encompasses a request from a taxpayer for an APA between the taxpayer and the Service, and also includes a request for a collaborative agreement between other relevant tax authorities (i.e., foreign tax authorities).

These are the preferred APAs, as proffered by the Service, due to their ability to ensure that there will be no double taxation related to an affiliate transaction. A unilateral APA involves only an agreement between the taxpayer and the Service.

Upon review of the APA request, in a bilateral or multilateral scenario, the Service will prepare a formal recommended negotiating platform for the U.S. competent authority (USCA). This negotiating platform is a basis for further discussions with the other relevant tax authorities (i.e., foreign tax authorities). In advance of finalizing its recommendation, the Service will convey the substance of the APA team's position to the taxpayer, allowing for any additional taxpayer comments. The Service will consider the additional taxpayer comments in finalizing its recommendation.

If the USCA and the other relevant tax authority(ies) come to a mutual agreement based on the USCA's recommended position, the taxpayer and the Service are approved to execute one or more APAs that are consistent with the mutual agreement.

The Analyst and the APA

Within the scope of providing transfer price services for clients, the analyst may be proactive in offering his or her services to those clients that have the potential for transfer pricing issues.

The analyst may look to collaborate with corporate counsel (or the corporate tax department) and provide assistance with the following:

1. Determining whether an APA is appropriate for a given transaction
2. Negotiating with the APA program and the USCA
3. Ensuring an accurate and reliable analysis of a potential APA
4. Dealing with any subsequent Service inquiries associated with the APA

This does not infer that the analyst should become an advocate for his or her client; rather, the analyst should thoroughly understand the applicable Internal Revenue Code Sections, regulations, and revenue procedures associated with APAs in hopes of minimizing the potential of an Service dispute.

Analysts can provide guidance in determining whether an APA may be a suitable strategy for a multinational enterprise.

Generally, an APA can assist a multinational enterprise that has experienced consistent transfer pricing audits with respect to similar disputes, has reached a negotiating impasse with a tax authority transfer pricing audit team, or has made significant changes to its business model and value chain.

In assisting with the up-front vetting of a potential APA, the analyst should also be prepared to provide support in comparing the up-front costs associated with finalizing an APA (i.e., direct and opportunity costs associated with the research, development, negotiation, and finalization of an APA) to the costs associated with preparing contemporaneous documentation as a result of a tax authority audit, defending against a tax authority audit, and obtaining final resolution of double taxation through negotiation or litigation with the relevant tax authority.

Generally, multinational corporations look for analysts and other APA advisers who possess the following skills:

1. Strong technical or analytical skills to apply to the APA process
2. Strong working relationships with tax authorities, including in-depth knowledge of the tax authority standard positions, practices, and strategies
3. Strong subject-industry knowledge and stakeholder engagement
4. Strong presentation and communication skills to assist in negotiating with the relevant tax authorities
5. A background in litigation assistance as well as tax-related assistance, which will provide value to the taxpayer should an APA result in tax-authority-based litigation

Other tasks that the analyst can assist a multinational enterprise with in navigating the APA process include the following:

1. Reviewing the details and circumstances surrounding transfer pricing issues and any ongoing tax authority audit activities
2. Developing transfer pricing strategies and policies for purposes of negotiating with the relevant tax authority
3. Assisting in the formal preparation of an APA, including providing guidance as to the appropriate transfer pricing method to be used in a transaction
4. Facilitating and assisting with APA prefiling conferences, site visits, post-filing inquiries, and document drafting
5. Assisting with the preparation of APA annual reports

Clearly transfer pricing is a relevant issue for both the Service and multinational corporations. Many recent professional periodicals have increased their focus on transfer pricing and APAs.

As presented in the *Journal of Accountancy*:

> Transfer pricing is in the cross hairs of tax policy as it relates to the competing objectives of three parties: the revenue-maximizing objective of the domestic tax authority, the revenue-maximizing objective of the foreign tax authority, and the tax-minimizing objective of the taxpayer. Because of the inherent differences in judgment and interpretation of facts when analyzing a company's transfer pricing, together with the clashing revenue objectives of multiple tax authorities and taxpayers, the risk of adjustments to taxable income, double taxation, and potential for penalties is nontrivial, even for multinationals that make good-faith efforts to comply with Sec. 482.[6]

As further documented in the *Journal of Accountancy*:

> The risk and uncertainty associated with transfer-pricing positions is expected to increase in coming years. Under pressure to raise revenue, governments are directing tax authorities to increase transfer-pricing audits. The Service has made a substantial investment in its transfer-pricing resources. Last year, the Large Business and International (LB&I) Division launched its international practice networks to unify international compliance functions and bring institutional expertise to bear on them. Transfer pricing is among the networks' top concerns (see "New LB&I Knowledge Management Strategies: IPGs and IPNs," *The Tax Adviser*, Oct. 2012, page 668). In the next two years, the Service will focus more transfer-pricing examination resources on medium-size taxpayers, those with assets as low as $10 million, than before (see "Practitioners Warn Middle-Market Companies of Heightened Transfer Pricing Scrutiny," *Tax Notes Today*, July 18, 2013).[7]

"The sheer amount of money at stake for many of the multinational corporations dealing with transfer pricing issues can easily justify the input of an experienced valuation analyst."

The sheer amount of money at stake for many of the multinational corporations dealing with transfer pricing issues can easily justify the input of an experienced analyst.

The analyst, using expertise with regard to tangible and intangible property transfer pricing and experience with Service standard operating procedures and strategies, can provide significant value to multinational taxpayers looking to:

1. minimize the risk of taxing authority audits on APA-related issues and
2. develop a coherent organization-wide APA plan and strategy.

Current APA Environment

Since the inception of the APA program, an annual report detailing the current environment of APAs is required to be presented to the public by the Secretary of the Treasury. As mentioned, one of the recent updates to the APA program was the changing of the name to the APMA (advance pricing and mutual agreement) program.

The annual APA program reports, covering the years 1991 through 2013, detail the experience, structure, and activities associated with the APA program for a given calendar year. Below is a summary of certain material APA program statistics as presented in the *Announcement and Report Concerning Advance Pricing Agreements*:

1. For the second year in a row the number of executed APAs increased (from 140 in 2012 to 145 in 2013).

Table 1
APA Applications Filed in 1991-2013

	Unilateral APAs	Bilateral APAs	Multilateral APAs	Total APAs
APA Applications Filed in 1991-1999				401
APA Applications Filed in 2000-2012	439	904	1	1,344
APA Applications Filed in 2013	20	89	2	111
Total APA Applications Filed in 1991-2013				1,856

Source: Richard J. McAlonan Jr., "Announcement and Report Concerning Advance Pricing Agreements" (March 27, 2014).

2. The median completion time of an APA decreased from 39.8 months (2012) to 32.7 months (2013).
3. The number of executed APAs (145) surpassed the number of applications filed (111) in 2013.
4. Of the bilateral APAs filed in 2013, nearly 75 percent involved Japan or Canada.
5. Of the APAs finalized or renewed in 2013, approximately 41 percent were for the wholesale/retail industry and approximately 35 percent were for the manufacturing industry.
6. Of the APAs executed in 2013, approximately 77 percent applied the comparable profits/transactional net margin method as the primary transfer pricing method.

In addition, Table 1 provides a historical view of APA activity since inception. It is apparent that the popularity of APAs has increased over the years, and will likely continue to do so as a result of the continued globalization of certain industries (and their respective multinational enterprises) and the tax authorities' constant goal of increased income tax revenue.

Summary and Conclusion

APAs are prospective arrangements negotiated between a taxpayer and the appropriate tax authority that confirm the proper pricing method and overall approach in an asset or service transaction between related entities.

The APA program was created as a result of the competing objectives of three parties:

1. The revenue-maximizing objective of the domestic tax authority
2. The revenue-maximizing objective of the foreign tax authority
3. The tax-minimizing objective of the taxpayer (i.e., multinational enterprise)

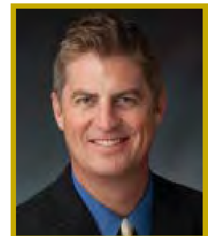
APAs represent a collaborative effort between the taxpayer and tax authorities in order to limit the inefficiency and risk associated with estimating an appropriate transfer price for relevant transactions. Due to the increased scrutiny of transfer prices by the Service and other taxing authorizes, APAs are gaining in popularity.

A thorough and well documented APA can help a taxpayer minimize the risk of income tax penalties related to an intercompany property or service transaction. Analysts can provide significant value to a multinational taxpayer by assisting with the development, negotiation, and finalization of an APA with the appropriate tax authority.

This discussion focused on the APA process and the recent popularity of advance pricing agreements. This discussion also highlighted the role that analysts can play in the APA process.

Notes:

1. The other area of international taxation where an analyst can provide guidance and assistance is customs valuation.
2. Treas. Reg. Sec. 1.482-1 (2012)
3. Local Finance Corp. v. Comm'r, 407 F.2d 629 (7th Cir. 1969).
4. Treas. Reg. Sec. 1.482-1 (2012)
5. Service Revenue Procedure 2006-9, page 3.
6. John McKinley, "Transfer Pricing and Its Effect on Financial Reporting—Multinational Companies Face High-Risk Tax Accounting," *Journal of Accountancy* (October 2013): 51.
7. Ibid.: 52.



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Important Considerations in the Pricing of Intercompany Loans and Financial Guarantees

Matt C. Courtnage

Over the past several years, taxing authorities have devoted increasing attention to intercompany loans and financial guarantees in terms of their tax treatment and pricing considerations. This attention is especially evident in the international arena, where cross-border financial transactions involving loan rates and guarantee fees can lead to profit erosion. For these intercompany financial transactions, there is a great deal of complexity for both the taxpayer and the national taxing authority in determining a reasonable arm's length transfer price. This discussion considers how the arm's-length standard is applied in the pricing of intercompany loans and financial guarantees, while recognizing the inherent benefits that come from being part of a multinational company.

Introduction

Intercompany financial transactions between related members of multinational entities can include a diverse range of financial agreements such as related-party loans, financial or performance-based guarantees, cash pooling, and factoring arrangements.

When companies engage in intercompany financial transactions, the Internal Revenue Service (the "Service") and other national tax authorities typically require that a transfer price be established for the subject transaction. Whatever the form of the intercompany financial transaction, for income tax purposes, these arrangements are considered "controlled" transactions.[1]

Intercompany transfer pricing rules indicate that for income tax purposes, these arrangements should be priced according to arm's-length transactions in which comparable, unrelated parties would enter into similar agreements.

This discussion focuses on what analysts (and other practitioners) should consider when pricing intercompany loans and financial guarantees for income tax purposes. The existing guidance from the Service and the Organization for Economic Co-operation and Development (OECD) for pricing intercompany loans and financial guarantees is somewhat vague and open to interpretation.

Additionally, it is often the case that finding an arm's-length comparable transaction may be difficult (or not feasible). This discussion also examines how the passive benefit bestowed on an entity purely based on its relationship with the parent company plays into the pricing of these financial arrangements.

While this discussion focuses on Service regulations, it also references OECD guidance due to the increasing worldwide attention of tax administrators on these matters.

Arm's-Length Price and Best Method Regulations

In general, Internal Revenue Code Section 482 ("Section 482") covers the distribution, apportionment, or allocation of income, deductions, credits, and allowances between related entities. At the

highest level, Section 482 states that the price for a transaction between related parties (e.g., a guarantee provided by a domestic parent company for the benefit of its foreign subsidiary) should be the same as if unrelated taxpayers had engaged in the same transaction under the same or similar circumstances. This is the arm's-length price principle.

Specifically, the Section 482 regulations state the following:

> 1.482.1(b)(1) Arm's length standard—In general. In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer. A controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result). However, because identical transactions can rarely be located, whether a transaction produces an arm's length result generally will be determined by reference to the results of comparable transactions under comparable circumstances.

Although Section 482 does not provide direct guidance regarding the appropriate method to estimate the arm's-length price for related-party loans, it does provide general information for choosing the most appropriate arm's-length method.

Under the best method rule, the most appropriate pricing method is the one that best approximates an arm's-length transaction given the specific facts and circumstances.

The Section 482 regulations state the following:

> 1.482-1(c) Best method rule—(1) In general. The arm's length result of a controlled transaction must be determined under the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result. Thus, there is no strict priority of methods, and no method will invariably be considered to be more reliable than others. An arm's length result may be determined under any method without establishing the inapplicability of another method, but if another method subsequently is shown to produce a more reliable measure of an arm's length result, such other method must be used. Similarly, if two or more applications of a single method provide inconsistent results, the arm's length result must be determined under the application that, under the facts and circumstances, provides the most reliable measure of an arm's length result.

There is no guidance beyond the best method definition as to what particular pricing methodology should be employed for pricing intercompany loans and financial guarantees.

Applicable methodologies are listed specifically for tangible property (Regulation 1.482-3(a)) and controlled services transactions (Regulation 1.482-9(a)), but neither loans nor guarantees are defined as belonging to one of these categories. Regulation 1.482-2, which covers loans, does not include a similar list of applicable methodologies.

It is important to note that Regulation 1.482-9 indicates that the pricing of financial transactions, including guarantees, are excluded from using the services cost method. This method is sometimes chosen by taxpayers because the service can be priced at cost and without any markup.

Interest Rate Regulations

Whatever methodology is used to price a related-party loan or financial guarantee, an appropriate arm's-length rate of interest for an uncontrolled, comparable transaction should be the guiding benchmark.

The regulations provide transfer pricing guidance that directly applies to interest rates established on an arm's length basis as follows:

> 1.482.2(a)(1)(i) Loans or advances—Interest on bona fide indebtedness—In general. Where one member of a group of controlled entities makes a loan or advance directly or indirectly to, or otherwise becomes a creditor of, another member of such group and either charges no interest, or charges interest at a rate which is not equal to an arm's length rate of interest (as defined in paragraph (a)(2) of this section) with respect to such loan or advance, the district director may make appropriate allocations to reflect an arm's length rate of interest for the use of such loan or advance.
>
> 1.482-2(a)(2) (i) Arm's length interest rate—In general. For purposes of section 482 and paragraph (a) of this section, an arm's length rate of interest shall be a rate of interest which was charged, or would have been charged, at the time the indebtedness

> arose, in independent transactions with or between unrelated parties under similar circumstances. All relevant factors shall be considered, including the principal amount and duration of the loan, the security involved, the credit standing of the borrower, and the interest rate prevailing at the situs of the lender or creditor for comparable loans between unrelated parties.
>
> (ii) Funds obtained at situs of borrower. Notwithstanding the other provisions of paragraph (a)(2) of this section, if the loan or advance represents the proceeds of a loan obtained by the lender at the situs of the borrower, the arm's length rate for any taxable year shall be equal to the rate actually paid by the lender increased by an amount which reflects the costs or deductions incurred by the lender in borrowing such amounts and making such loans, unless the taxpayer establishes a more appropriate rate under the standards set forth in paragraph (a)(2)(i) of this section.

It is important to note that the regulations do provide guidance for pricing U.S. dollar denominated loans, which includes an associated "safe haven" interest rate based on the applicable federal rate (AFR). Many taxpayers rely on this safe haven provision because the interest rate calculation is straightforward and allows entities to avoid determining and documenting a true arm's-length rate of interest.

There are a number of pitfalls, however, with taking this approach. The AFR only covers three maturity ranges: 0-3 years (short-term rate), 3-9 years (mid-term rate), and 9+ years (long-term rate). The rates make no differentiation for differences in entity characteristics such as size, industry, type of business, and so forth.

Utilization of these rates is especially troublesome in cases of loans to foreign entities where additional political, economic, and currency risk may exist.

For these reasons, the limited AFR-based options typically will not fully capture the true credit risk of subsidiaries. Finally, loans made in foreign currency are excluded from utilizing the safe haven provision and the associated AFRs.

Many analysts have recommended expanding the array of AFRs to consider various entity and industry-specific risk characteristics. This would allow multinational entities to utilize the safe haven application while still reasonably accounting for necessary risk parameters. To date though, there has been no concrete action towards expanding and differentiating these rates.

Under the current regulations, the inherent contradiction is that while the regulations clearly state that the interest rates on intercompany loans should follow the arm's-length standard, the regulations also allow for safe haven rates that are often inconsistent with independent and unrelated entity transactions.

Furthermore, AFR rates that tend to be relatively low, because of their composition of blended U.S. Treasury rates, are unlikely to be accepted by foreign tax authorities in transfer pricing disputes.

Passive Association Benefit Guidance

A subsidiary generally receives some level of implicit benefit from its relationship with the parent company. This benefit is referred to as a "passive association benefit."

As an example, a subsidiary is likely to have easier access to credit markets than a stand-alone entity, even without any explicit backing from the parent. This type of association and related benefit is deemed passive in nature and is increasingly recognized in transfer pricing cases.

This passive versus explicit benefit can be an important distinction in instances where the general association and implicit backing from a multinational parent can lead to more favorable credit terms for a subsidiary based on that relationship as compared to a stand-alone, uncontrolled entity comparable.

Regulation 1.482-9(l)(3)(v) addresses the benefit of passive association among related party members of a controlled group, as follows:

> A controlled taxpayer generally will not be considered to obtain a benefit where that

> benefit results from the controlled taxpayer's status as a member of a controlled group. A controlled taxpayer's status as a member of a controlled group may, however, be taken into account for purposes of evaluating comparability between controlled and uncontrolled transactions.

Examples 15 through 17 in Regulation 1.482-9 address whether or not a benefit is received by a foreign subsidiary due to specific actions of the domestic parent company or by a passive association with the parent company.

The foreign subsidiary in example 15 was determined not to have received a benefit because the ability of Company Y (the foreign subsidiary) to obtain the contract, or to obtain the contract on more favorable terms than would have been possible prior to its acquisition by Company X [the domestic parent] controlled group, was due to Company Y's status as a member of the Company X controlled group and not to any specific activity by Company X or any other member of the controlled group.

Chapter 7.13 of the OECD guidelines has similar language, and it is even specific to the impact that such association may have on a related party's entity's ability to obtain credit on more favorable terms.

> For example, no service would be received where an associated enterprise by reason of its affiliation alone has a credit-rating higher than it would if it were unaffiliated, but an intra-group service would usually exist where the higher credit rating were due to a guarantee by another group member.

From a pricing perspective, this passive association benefit can have significant implications for a subsidiary. In such a case, a stand-alone firm's ability to access the credit market would be entirely dependent upon its own ability to generate sufficient cash flow to cover the required loan payments.

In the case of a controlled subsidiary, the credit markets would likely make some assumption regarding the parent company's likelihood to intervene if the subsidiary encounters financial difficulty. Even if this is just implicit support—that is, no formal guarantee is made—the credit markets will likely regard the entity differently than a stand-alone comparable.

In effect, the related-party subsidiary will carry a de facto higher credit rating and will likely have access to more funds and/or at lower comparable rates of interest.

OECD Guidance Distinctions

While the OECD guidance and the Treasury regulations on transfer pricing generally follow one another in terms of language and viewpoint, it is important that analysts be aware of substantive differences that could lead to separate transfer pricing rates for the domestic parent and foreign borrower.

While the OECD guidelines are not mandatory for its member countries, numerous member and nonmember countries adhere to the OECD guidance and incorporate the OECD guidelines into their own tax laws. The differences between OECD guidance and regulations for transfer pricing in terms of intercompany loans and financial guarantees are primarily semantic in nature.

For example, the Section 482 regulations specify the "best method" while the OECD guidelines specify the "most appropriate method." The OECD guidelines, like the Treasury regulations, give priority to transactional methods and are more specific by stating in Chapter 2.14 the following:

> Where it is possible to locate comparable uncontrolled transactions, the CUP method is the most direct and reliable way to apply the arm's length principle. Consequently, in such cases the CUP method is preferable over all other methods.

As noted above, while the regulations do allow for safe haven pricing based on AFRs in certain cases, the OECD guidelines make no reference to safe haven or other default-type pricing. The focus, instead, is solely on the arm's-length price approach.

The OECD guidelines make it clear that loans and financial guarantees are intercompany services, while the regulations do not consider them to be in any particular category.

Except for the disallowable use of the services cost method under the regulations, there is no further indication that these categorization differences would lead to significant pricing differences.

Except for the regulations' permissible use of safe haven rates, there are no substantial differences between the Treasury regulations and the OECD guidelines in terms of the underlying methods, rules for which methods to use, or how the methods should be applied in pricing intercomapny loans and financial guarantees.

Loan Pricing

As previously stated, the regulations do not provide direct guidance related to the transfer price of intercompany loans and financial guarantees.

If the analyst determines that a transfer price adjustment is appropriate for an intercompany loan or financial guarantee—that is, the analyst determines that the interest rate on the intercompany loan or the parent company guarantee confers an economic benefit to the recipient and that the recipient would be willing to pay an unrelated party for that benefit—then the analyst should consider the appropriate method.

While there are many different methods an analyst may consider, the following typically are the most applicable for determining arm's-length interest rates and related guarantee fees:

1. Comparable uncontrolled prices (CUP)
2. Price quotations
3. Insurance pricing models
4. Standby letters of credit
5. Credit default swaps
6. Put options

The first two methods are based on direct comparable market indications, while the later four methods are equivalent to the pricing of a hedge on the underlying loan that would effectively eliminate default risk.

In a survey of financial professionals in 40 countries by PricewaterhouseCoopers, the CUP method was the most used pricing methodology for establishing arm's-length interest rates for related party loans.[2]

According to this survey, and as shown in Figure 1, 84 percent of respondents said they used the CUP method based on external transactions.

Whatever approach is taken, typically, the first procedure in pricing an intercompany loan is to estimate the borrower's credit rating.

This procedure requires two ratings. The first being a true stand-alone rating with no implicit benefit for passive association (either with a parent corporation or a related subsidiary), and the second being a stepped up rating reflecting the implicit benefit provided by any passive association. These two ratings can then serve as a floor and ceiling for pricing the subject intercompany loan.

If a credit rating has already been assigned for the borrower by a rating agency, such as Standard & Poor's or Moody's, then the primary question is whether it already reflects the benefit of passive association. If a rating has not been assigned, it is necessary to determine a hypothetical rating.

This procedure can be achieved through the use of a credit model based on the borrower's industry, size, and key financial ratios. A passive benefit step up can then be applied, if appropriate.

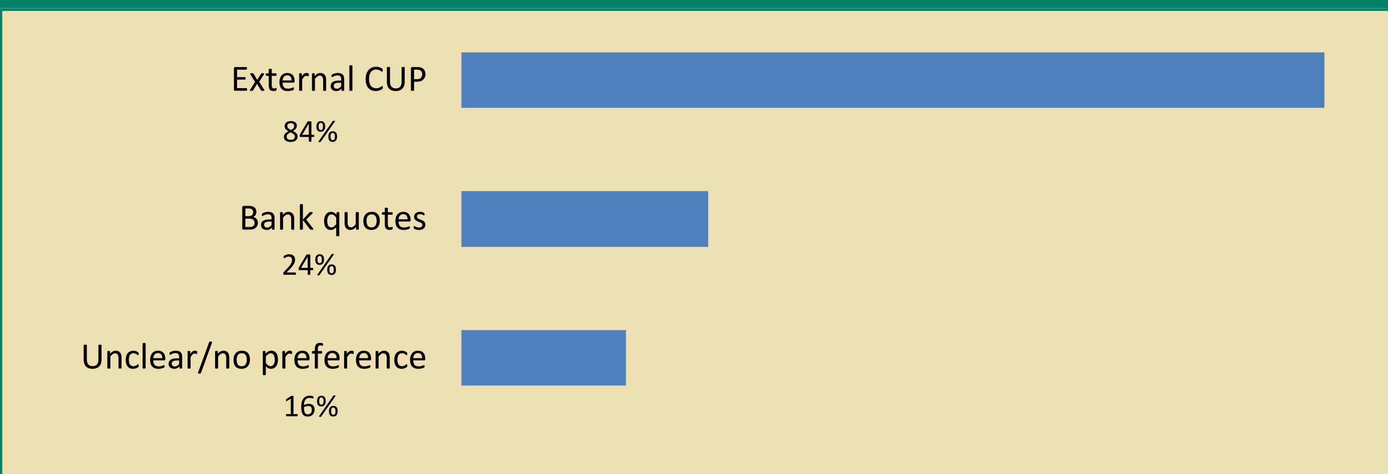
Once the credit ratings are determined, choosing market comparables is the next step. The bond yield market and corporate loan data are common sources which can be aggregated in order to make a best effort at mirroring the financial standing of a particular entity.

These stratifications may include the following attributes depending on the specifics of the subject transaction:

1. Currency
2. Timing of the transaction
3. Principal amount
4. Duration of the loan
5. Embedded loan rights

While an entity's credit rating gives a good indication of its borrowing cost, the loan-specific

Figure 1
Generally Accepted Methods to Evaluate Arm's Length Interest Rates on Intercompany Loans



factors above may also exert a strong influence on the interest rate of a given loan. An analyst searching for comparable loans may attempt to match the entity credit rating and as many of the above-listed loan attributes as possible.

Loan Guarantee Considerations

A guarantee on a particular loan has the effect of raising the creditworthiness of the borrower via a pledge of security by a third party for that loan.

A partial guarantee will raise that creditworthiness to some point between the borrower's stand-alone credit rating and that of the guarantor. A full guarantee should, in theory, raise the borrower's credit rating up to the level held by the guarantor.

Three important factors need to be considered when pricing a loan guarantee:

1. Whether the guarantee confers a benefit
2. Whether the guarantee is implicit or explicit
3. Whether the guarantee should be considered a service or a capital contribution

For a loan guarantee to be considered a compensable service, the guarantee must be explicit and confer a tangible benefit. Even if the guarantee is explicit and confers a benefit, an intercompany fee should only be charged if the benefit of the guarantee exceeds the benefit that would have been accrued through any implicit guarantees from the parent company.

An example of a guarantee that does not meet the criteria of a compensable service for transfer pricing purposes is provided in example 18 of Regulation 1.482-9. In this example, Company X (the parent company) sends a letter to the financial institution in Country B, which represented that Company X had a certain percentage ownership in Company Y (the foreign subsidiary) and that Company X planned to maintain that ownership.

This allowed Company Y to obtain more favorable terms on its contract but, for taxation purposes, it is not considered a chargeable service because it was neither an explicit guarantee nor a tangible benefit. This type of implicit guarantee is often referred to as a "comfort letter" and no transfer price is necessary in this instance.

Another caveat with loan guarantees is the manner in which the transaction is structured. In some cases, the tax administrator may be of the opinion that the underlying economic substance of a transaction aligns more with a different classification of the transaction.

This is especially true for controlled transactions where a subsidiary is significantly undercapitalized or newly created with the sole purpose of undertaking a specific contract.

The OECD addresses this issue in its guidelines, while the Treasury regulations lack similar guidance. Paragraph 1.65 of the OECD guidelines includes the following:

> The first circumstance arises where the economic substance of a transaction differs from its form. In such a case the tax administration may disregard the parties' characterisation of the transaction and re-characterise it in accordance with its substance. An example of this circumstance would be an investment in an associated enterprise in the form of interest-bearing debt when, at arm's length, having regard to the economic circumstances of the borrowing company, the investment would not be expected to be structured in this way. In this case it might be appropriate for a tax administration to characterise the investment in accordance with its economic substance with the result that the loan may be treated as a subscription of capital.

On November 26, 2013, the Netherlands released a decree on transfer pricing that addressed the issue of guarantee fees in terms of whether they should be considered a chargeable group service.[3]

According to the decree, it is assumed an independent third party will generally not provide a loan to an entity that lacks an investment grade credit rating. To the extent that a borrower could not independently raise a loan on its own, either with or without a third-party guarantee, then the related party parent guarantee transaction does not involve a chargeable intercompany service.

Instead, the guarantee should be viewed as (1) provided in a shareholder capacity and (2) specifically as a constructive capital contribution from the parent to the subsidiary.

In the OECD action plan on base erosion and profit shifting, the organization specifically calls out the need for further development of guidance linked to related-party financial and performance guarantees as a means to limit excessive financial payment deductions.[4]

Changes to the OECD transfer pricing guidelines are expected in December 2015.

Loan Guarantee Pricing

The process for pricing related-party loan guarantees is analogous to the process for pricing intercompany loans. As with intercompany loans, the first procedure is to determine the subsidiary's stand-alone credit rating. Then, through the identification of third-party pricing data and the selection of comparable transactions, a benchmark for a comparable, uncontrolled interest rate can be established.

This interest rate should then be compared to the loan rate received by the subsidiary that has the attached parent company guarantee. It does not matter if the loan originated from the parent or was obtained from an independent third party.

The point is that the higher rate determined under an uncontrolled pricing methodology should serve as a benchmark for the combined pricing of the controlled loan interest rate and the pricing of the guarantee. Like an interest rate, the guarantee fee typically is in the form of an annual percentage rate on the unpaid principal balance of the loan.

The difference between the uncontrolled interest rate and the related-party loan rate obtained by the borrower sets an upper boundary for the pricing of the guarantee. The reason this serves as an upper boundary is that this would represent the most that the subsidiary would pay for the guarantee in an uncontrolled transaction.

It would, in effect, leave the subsidiary ambivalent as to whether it would choose to:

1. obtain a lower rate loan secured by a guarantee from the parent,
2. obtain a lower rate loan secured by a guarantee from an independent third party, or
3. obtain a higher rate loan without a guarantee.

The combined uncontrolled pricing conclusions would be equal for each scenario.

This approach of measuring the benefit conferred with and without the guarantee is commonly referred to as the "yield approach" or the "benefit approach."

Once the ceiling price for the guarantee has been estimated, establishing the transactional transfer price is less straightforward. At issue is the level of implicit benefit that should be factored into the equation.

It is reasonable to expect that the parent company would not charge the subsidiary the full uncontrolled price of the guarantee. The parent company's influence, via ownership control, of the subsidiary makes the security provided by the guarantee less risky and potentially less costly than the security provided by an independent third-party guarantee.

A somewhat simplistic procedure would be to share the economic profit generated by the guarantee. In this approach, the transfer pricing floor is an estimated cost to the parent of providing the guarantee and the ceiling is a stand-alone price the subsidiary would have paid an independent third party for the guarantee.

A rate between these two benchmarks would likely be considered arm's length. This subject will be addressed further below in a judicial decision involving General Electric.

Another procedure to calculating a lower bound for the related-party loan guarantee is to establish how much additional equity capital a parent would need to contribute to the subsidiary in order for the borrower to achieve a credit rating that would allow it to obtain the loan in an arm's-length transaction at the same interest rate obtained through the controlled transaction.

Generally, a guarantor would charge a price that is at least large enough to cover the expected loss of equity in the event of default, plus a profit element.[5]

General Electric Capital Canada

A 2009 high profile judicial decision that includes many of the topics addressed in this discussion is the General Electric Capital Canada (GECC) decision.[6] In that matter, GECC issued commercial paper that was backed by an explicit guarantee from GE Capital US (GECUS), for which GECC paid GECUS 100 basis points.

Canadian tax authorities deemed this price to not be arm's length, arguing that in the absence of the guarantee, the GECC credit rating would have been

"The benefit that a borrower may accrue from its status as a related-party entity in a multinational corporation may be considered in establishing transfer pricing rates for loans and financial guarantees."

equal to that of GECUS solely based on the subsidiary's status as an associated entity.

This view takes an extreme interpretation of the passive association benefit, whereby only the parent's credit rating is applicable in determining loan rates and guarantee fees. The decision was appealed by GECC.

In ruling on the appeal, the Tax Court of Canada used both a stand-alone approach and the concept of implicit support conveyed by the parent to determine an appropriate credit rating for GECC. The Tax Court of Canada recognized that implicit support has real, but limited value.

The explicit support provided by the guarantee that brought the rate down to a level in line with the parent's credit rating conferred a tangible benefit.

The Tax Court of Canada ruled that the interest cost savings to GECC was determined to be 183 basis points based on a purely stand-alone credit rating relative to the parent rating.

The Tax Court of Canada ruled that the guarantee fee of 100 basis points originally established by GECC and GECUS was arm's-length in light of the implicit support the subsidiary gained via its status as a related-party entity.

This judicial decision clarified that the implicit support provided by a parent to a subsidiary is economically relevant, but the extent of that value is limited and remains open to interpretation. A rate below arm's length was allowed in this matter, but the process of quantifying and applying an implicit support adjustment was not clarified.

Conclusion

There are many issues surrounding the determination of intercompany transfer pricing rates for loans and financial guarantees. At a base level, these issues relate to whether the subject loan or financial guarantee confers a benefit and whether the transaction merits transfer pricing consideration.

To the extent that the borrowing subsidiary could feasibly obtain a loan from an independent third-party lender without a guarantee and an explicit benefit that has been provided by the parent, then a transfer pricing rate must be established.

Guidance and regulations on transfer pricing for financial transactions continue to receive increasing attention and recent rulings in court cases involving multinational entities often seem to make their own interpretation of existing guidance.

Many countries have added regulations that go beyond the more general guidance offered by the OECD.

For these reasons, when establishing transfer pricing rates for loans and financial guarantees, analysts may consider each of the following:

1. Regulations in the parent company's country
2. Regulations in the subsidiary's country
3. OECD guidance
4. Relevant court cases that might influence the respective tax administrators

The benefit that a borrower may accrue from its status as a related-party entity in a multinational corporation may be considered in establishing transfer pricing rates for loans and financial guarantees.

This association benefit is recognized by both the Service and OECD, but there remains no standard method or guidance for quantifying that level of benefit. Any credit rating step up or other adjustment mechanism to reflect an association benefit may certainly require adequate documentation and a well-reasoned supporting rationale.

Notes:

1. A controlled transaction is a transaction in which a financial agreement is made between two or more enterprises that are associated enterprises with respect to each other. http://www.oecd.org/ctp/glossaryoftaxterms.htm.
2. http://www.pwc.com/managingthecomplexity.
3. 14 November 2013 no. IFZ 2013/184 M.
4. http://www.oecd.org/ctp/BEPSActionPlan.pdf.
5. BNA, Inc., *Daily Tax Report* 8, No. 15 (January 24, 2008).
6. General Electric Capital Canada Inc. v. The Queen, 2009 TCC 563 (Dec. 4, 2009).

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The Impact of the Standard of Value on Transfer Pricing and Financial Accounting in the United States

Stephen P. Halligan

Tangible property and intangible property are valued in a variety of different contexts and for a variety of different reasons. As such, multiple standards of value have developed, not all of which yield equivalent results for the same property. One context in which tangible property and intangible property are valued is income-tax-related intercompany transfer pricing. In estimating a value for tangible property and intangible property in this transfer pricing context, the analyst should understand the nuances of the arm's-length price standard and how it differs from the fair value and fair market value standards of value. This discussion (1) provides an overview of the different standards of value used for financial reporting and tax-related transfer pricing purposes and (2) analyzes the similarities and differences between fair value and the arm's-length price standard of value.

Introduction

Multinational companies often transfer tangible and intangible property from a U.S. parent corporation to foreign subsidiaries or to other affiliated entities.

Analysts are often asked to estimate the transfer price of the tangible property and/or intangible property for income tax purposes. The transfer price is important for establishing and reporting the correct tax base of the transferred property. If the Internal Revenue Service (the "Service") believes that the intercompany transfer price is incorrect or "mispriced," the Service may call for transfer price adjustments to be made.

Understanding the transfer pricing regulations and how the selected standard of value can affect the transfer price conclusion are important considerations in any transfer pricing analysis.

In the United States, the analyst can rely on several different standards of value depending on the purpose of a valuation assignment. The purpose of a valuation, and the standard of value that is applied, can have significant effects on the subject property value conclusion. In other words, valuations performed for different purposes, using different standards of value, can result in different value conclusions. These different value conclusions can be attributed to differences in the definition (and intent) of the standard of value. The appropriateness of the standard of value depends on the context and purpose of the valuation.

Fair market value, the standard of value used in valuations prepared for certain federal tax matters, is generally considered by courts and other income tax practitioners to be consistent with the arm's-length price standard, the standard of value used in transfer pricing analyses.

Not far removed from the two aforementioned standards of value is *fair value*. Fair value is the standard of value used for U.S. generally accepted accounting principles (GAAP) financial reporting purposes.

In general, each of these standards of value attempts to estimate the price of a property that would be agreed to by independent parties. If all

three standards attempt to estimate a price that would be agreed to by independent parties, one may conclude that they should yield equivalent results. However, this is not always the case. This is because these three standards of value diverge from each other in subtle yet significant aspects.

This discussion examines and compares three valuation standards, fair value, fair market value, and arm's-length price. It also addresses why analysis performed under these three seemingly equivalent standards will not always equate.

Valuation Standards

In the United States, the standard of value used for financial accounting is fair value. Fair value is defined by the Financial Accounting Standards Board (FASB) in Accounting Codification Standards topic 820 (ASC 820), as follows:

> Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction in the principal (or most advantageous) market at the measurement date under current market conditions (that is, an exit price) regardless of whether that price is directly observable or estimated using another valuation technique.[1]

In addition to the fair value standard used in financial reporting, there is also fair value derived from state shareholder rights statutes. This statutory fair value standard of value is typically the standard applied in valuations related to dissenting shareholders or minority oppression actions. The definition of fair value in this context can vary from state-to-state, and sometimes even among courts within the same state. Fair value is also the standard used by some states for marital dissolution matters.

For this reason, analysts work closely with client legal counsel to understand the statutes and relevant standards of value applicable to the subject analysis.

Under U.S. income tax law,[2] fair market value is the relevant standard of value for income tax purposes. Fair market value is not explicitly defined in the Internal Revenue Code, but it is defined in the Treasury regulations (the "regulations"). The regulations generally carry the full force of law in the United States.[3]

The Treasury regulations define fair market value as follows:

> The price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts.[4]

Despite fair market value being considered the relevant standard of value under U.S. tax law, the arm's-length price standard may also be applicable in certain income tax matters, such as for intercompany transfer pricing purposes.

The arm's-length price standard states that the amount charged by one related party to another for a given product should be the same as if the parties were not related. The definition of arm's-length price as it applies in the United States is presented in the Section 482 regulations.

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 (arm's length result).[5]

Although the arm's-length price standard is the relevant standard of value for intercompany transfer pricing purposes in the United States, other standards may be applied by international tax authorities. For example, the Organisation for Economic Co-Operation and Development (OECD) provides the authoritative international definition of the arm's-length principle. This standard of value is applicable for intercompany transfer pricing purposes in many other (non-U.S.) countries.

According to the OECD:

> [Where] conditions are made or imposed between the two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.[6]

For purposes of this discussion, it is important to recognize the differences between the Treasury regulation definition and interpretation of the arm's-length price standard and the OECD definition and interpretation of the arm's-length principle.

In general, however, these two definitions and standards are largely equivalent, and an in-depth

analysis comparing and contrasting the subtle differences between these definitions is beyond the scope of this discussion. For this discussion, we rely on the Treasury regulation definition of the arm's-length price standard.

Arm's-length price standard and fair market value have subtle differences. However, for purposes of this discussion, these differences will also be omitted and we will assume them to be equivalent. This assumption comports with the general position taken by many practitioners.

Comparison of Arm's-Length Price and the Fair Value Standard

Fair value and arm's-length price are not directly compared to each other in the Internal Revenue Code, the regulations, or in ASC 820. However, the definitions can be compared by analyzing certain key attributes of value that are identified in each definition.

Table 1 is reproduced (with minor editorial changes) from an April 2011 article in *Tax Notes International*.[7] The table presents a comparison of the following specific attributes of arm's-length price and the fair value standard of value, based on the current definitions of each standard:

1. The controlled transaction
2. The application context
3. The comparable transaction
4. The valuation

Table 1
Comparison of the Arm's-Length Price Standard and the Fair Value Standard

	Arm's-Length Price Standard (Based on Section 482)	Fair Value Standard (Based on ASC 820)
Subject Transaction	Recognized as actually structured	Recognized as actually structured
Application Context	Dual perspective	Single perspective
Comparable Transaction	Independence requirement Comparability requirement: - Actual transaction - Actual transaction - Actual participants - Actual market	Independence requirement Comparability requirement: - Actual object - Hypothetical transaction - Hypothetical participants - Hypothetical market
Valuation	Pretax basis Arm's-length range Profit maximization	Post-tax basis Highest and best use principle Profit maximization
End Result	Subjective, entity-specific value	Objective, value

The Subject Transaction

As stated above, arm's-length price and the fair value standard are similar in regards to the subject transaction. For both, the subject transaction is recognized as it is actually structured.

The regulations establish that "[t]he Commissioner will evaluate the results of the transaction as actually structured by the taxpayer unless its structure lacks economic substance. However, the Commissioner may consider the alternatives available to the taxpayer in determining whether the terms of the controlled transaction would be acceptable to an uncontrolled taxpayer faced with the same alternatives and operating under comparable circumstances."[8]

For transfer pricing purposes, the subject transaction involves the transfer of property or services between related companies that belong to the same multinational enterprise group. These transactions are referred to as "controlled" transactions, or non-arm's-length transactions.

Controlled transactions are distinctly different from uncontrolled transactions. Uncontrolled transactions occur between companies that are assumed to operate independently from each other, or on an arm's-length basis.

For financial accounting purposes, the FASB offers a similar position in ASC 820 by stating, "A fair value measurement is for a particular asset or liability. Therefore, when measuring fair value a reporting entity shall take into account the characteristics of the asset or liability if the market participants would take those characteristics into account when pricing the asset or liability at the measurement date."[9]

These characteristics often include the condition and location of the asset, and whether or not there were any restrictions on the sale or use of the asset at the time of the transaction.

Comparing the two standards from a broad perspective, it is evident that both standards attempt to evaluate the economic structure of the subject transaction based on the transaction characteristics that unrelated parties would use to determine a price for the subject transaction.

Adjustments to the structuring of the transaction can occur in the arm's-length price,

but only if the Service believes the structure lacks economic substance (i.e., was not comparable to an uncontrolled transaction of similar nature).

The Application Context

For intercompany transfer pricing purposes, the context of the subject transaction is analyzed from a dual prospective. That is, in a transfer pricing analysis, the interests of both the buyer and the seller, both dealing at arm's length, are evaluated to determine a price for the subject transaction.

By comparison, the objective of a fair value financial accounting analysis is to determine an exit price that would be received to sell an asset or paid to transfer a liability,[10] which effectively is a one-sided perspective.

Transactions that consider only one perspective can result in a value that is different than if both the buyer's perspective and the seller's perspective are considered. This is because by only considering the transaction from the perspective of the seller, and not the buyer, the analyst may omit pertinent information about what the buyer stands to gain in the transaction.

In other words, the potential benefits of the subject transaction, negotiated from the buyer's perspective, can have an influence on the arm's-length price of the subject transaction.

Thus, arm's-length price attempts to estimate the price of a transaction by including factors that are relevant to each specific buyer *and* seller.

The inclusion of such factors in an analysis leads the arm's-length price standard towards a more subjective and company-specific value conclusion. Fair value, which as noted is a one-sided perspective, generally leads to a more objective valuation analysis and value conclusion.

The Comparable Transaction

For transfer pricing purposes, analysts typically use methods that rely on comparable uncontrolled transactions. These comparable uncontrolled transactions provide market-based transactional data involving property comparable to the subject property that was transacted under circumstances comparable to the subject transaction.

The lack of data on such comparable transactions can make a particular method more or less reliable, and even inapplicable. The comparable transactions are referred to as uncontrolled transactions because the parties involved in the transactions are independent of each other.

In the context of both arm's-length price and the fair value standard, a comparison between a controlled transaction and a comparable transaction may be required. In the process of selecting and analyzing potentially comparable transaction(s), the two standards diverge in a few subtle, but important, ways. The primary differences relate to the following:

1. The reference transaction
2. The market where the reference transaction occurs
3. The participants involved in the reference transaction

These three differences are discussed next.

The Reference Transaction

When performing an analysis within the arm's-length price and the fair value context, one consideration is the reference transaction. The two valuation frameworks differ on what types of reference transactions should be analyzed in the valuation.

According to the regulations, when estimating the true taxable income of a controlled taxpayer, the standard to be applied "in every case"[11] is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer (i.e., unrelated or unaffiliated).

The 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.

However, because identical uncontrolled transactions can rarely be located, whether a transaction produces an arm's-length result generally will be determined by reference to the results of comparable transactions under similar circumstances.[12]

By comparison, ASC 820 does not require an actual transaction to have occurred in order for it to have a fair value. According to ASC 820, fair value is based on an "orderly transaction" between market participants.[13]

An orderly transaction is not necessarily a real transaction. In fact, an orderly transaction can be a hypothetical transaction that is assumed to have taken place on the measurement date. This hypothetical transaction assumes that the subject asset has been exposed to the market for the usual and customary period of time for marketing activities.

In this regard, the fair value standard directly conflicts with the arm's-length price standard. In other words, the two standards are different with regard to the reference transaction. This is because the reference transaction(s) in a fair value analysis may include *hypothetical* comparable transactions and, conversely, the reference transaction(s) in an

arm's-length analysis are typically considered to be *actual* comparable transactions.

The Reference Market

The market in which the reference transaction is expected to have taken place is also a noteworthy difference between the two standards. Fair value assumes that the transaction to sell the asset or transfer the liability occurs in the principal or most advantageous market to the reporting entity.[14]

Within the principal market, the reporting entity is able to sell the asset or transfer the liability at the price that maximizes the amount that would be received for the asset or, minimizes the amount that would be paid to transfer the liability.

The regulations offer different guidance on selecting the comparable transactions, noting that comparable transactions should be derived from a comparable geographic market[15] in which the taxpayer operates and how there may need to be adjustments based on location savings.[16]

This guidance implies that the comparable transaction need not occur in the principal or most advantageous market. This is an important consideration, because there may be significant differences in the economic conditions between markets and/or countries (i.e., the actual market may not be the same as the most advantageous market).

The Participants

The regulations indicate that comparable transactional data involving unrelated parties provide the most objective basis for determining whether a controlled transaction is at arm's length. In this context, unrelated parties are generally considered to be unrelated, actual market participants.

By comparison, the fair value standard supports the use of hypothetical market participants. According to ASC 820, "a reporting entity need not identify specific market participants. Rather, the reporting entity shall identify characteristics that distinguish market participants generally."[17]

The difference between the two frameworks' interpretation of the reference transaction participants is, as mentioned above, whether or not they are actual or hypothetical participants. Arm's-length price supports the use of actual market participants involved in actual market transactions.

The fair value standard does not require the use of actual transaction and supports the use of hypothetical market transactions involving hypothetical market participants.

The Analysis

In comparing the analytical processes of the arm's-length price standard and the fair value standard, both standards are transactional and price based.[18] Although the actual analytical process is quite similar between the two standards, there are two important differences that can yield materially different values in most instances.

The Treasury regulations and the accounting standards have differing aspects on how the property involved should be taxed and by what application (e.g., the use of the asset) they should be assessed. These two issues are discussed next.

Tax Treatment

Fair value analyses prepared for financial accounting purposes are generally prepared on an after-tax basis. Buy-in price analyses prepared for transfer pricing purposes are sometimes prepared on a pretax basis.

The issue with these procedures, and where they conflict, is that something that is transacted is, by its very nature, a pretax transaction price, regardless of the basis used to determine that price.

In both fair value and the arm's-length standard, it is assumed that both the buyer and seller are knowledgeable of the relevant facts and are rational. Rational and independent parties would consider the tax consequences of transactions when evaluating price, which could cause different buyers to estimate different values for the same subject property.

Regulation 1.482-7 discusses the pretax basis of transfer pricing under multiple circumstances, specifically the investor model, discount rates, and the income method:

> *Treas. Reg*. §1.482-7(g)(2)(iii)—Consistency of evaluation with realistic alternatives
>
> In general. The relative reliability of an application of a method also depends on the degree of consistency of the analysis with the assumption that uncontrolled taxpayers dealing at arm's length would have evaluated the terms of the transaction, and only entered into such transaction, if no alternative is preferable. . . .In principle, this comparison is made on a post-tax basis but, in many cases, a comparison made on a pre-tax basis will yield equivalent results [emphasis added].
>
> *Treas. Reg.* §1.482-7(g)(2)(v)(B)(4)—Discount Rates
>
> Post-tax rate. In general, discount rate estimates that may be inferred from the

operations of the capital markets are post-tax discount rates. Therefore, an analysis would in principle apply post-tax discount rates to income net of expense items including taxes (post-tax income) [emphasis added]. However, in certain circumstances the result of applying a post-tax discount rate to post-tax income is equivalent to the product of the result of applying a post-tax discount rate to income net of expense items other than taxes (pre-tax income), and the difference of one minus the tax rate. Therefore, in such circumstances, calculation of pre-tax income, rather than post-tax income, may be sufficient.

Treas. Reg. §1.482-7(g)(4)(i)(G)—Income method

The effect of taxation on determining the arm's length amount. (1) In principle, the present values of the cost sharing and licensing alternatives should be determined by applying post-tax discount rates to post-tax income (including post-tax value to the controlled participant of the PCT [platform contribution transaction] Payments) (emphasis added). If such approach is adopted, then the post-tax value of the PCT Payments must be appropriately adjusted in order to determine the arm's length amount of the PCT Payments on a pre-tax basis.

The tax treatment under the regulations is meant to provide a shortcut that ensures both the buyer and the seller are willing to enter into the transaction in question after tax costs and benefits are taken into account. The different tax treatments used in the two standards of value may lead to differences in the analysis conclusion.

Arm's-Length Price Range and the Highest and Best Use Principle

Estimating the value of an asset or liability under the fair value standard assumes the asset(s) will be used at the highest and best use (HABU). According to ASC 820, "Highest and best use is determined from the perspective of market participants, even if the reporting entity intends a different use. However, a reporting entity's current use of a nonfinancial asset is presumed to be its highest and best use unless market or other factors suggest a different use by market participants would maximize the value of the asset."[19]

The definition provided by FASB considers that the HABU of an asset (i.e., the use that provides the most profit return on the asset) is the one for which it is to be used.

By comparison, the arm's-length price standard attempts to estimate the price of a transaction based on the results of comparable transactions. "In some cases, application of a pricing method will produce a single result that is the most reliable measure of an arm's length result. In other cases, application of a method may produce a number of results from which a range of reliable results may be derived. A taxpayer will not be subject to a transfer pricing adjustment if its results fall within such range (an arm's length range)."[20]

". . . using the HABU will maximize the asset value by assuming the subject property is sold into the most advantageous market, even if the subject asset currently is not being used in that market."

Based on the HABU analysis, and assuming all other factors are held constant, the fair value standard may result in the same, or greater, value than the arm's-length price standard. This is because the fair value standard uses a single-sided perspective from the side of the seller.

That is, using the HABU will maximize the asset value by assuming the subject property is sold into the most advantageous market, even if the subject asset currently is not being used in that market.

On the other hand, the arm's-length price appears to take a more unbiased (or neutral) prospective with regard to the subject market. This is because arm's-length price considers both the buyer and seller (i.e., it employs a dual-sided perspective).

Conclusion

This discussion provided an overview and comparison of the arm's-length price standard and the fair value standard. The arm's-length price standard and the fair value standard are distinct standards of value that differ in several significant aspects.

The arm's-length price standard considers the motivations of both buyers and sellers in transactions. That is, it attempts to perform the analysis from an unbiased, dual-sided perspective. The arm's-length price standard relies on actual comparable uncontrolled transactions to estimate the arm's-length price of a controlled transaction.

The analysis conclusion of an arm's-length price analysis is typically a range of prices from which the

continued on page 64

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A PRACTICAL GUIDE TO BANKRUPTCY VALUATION

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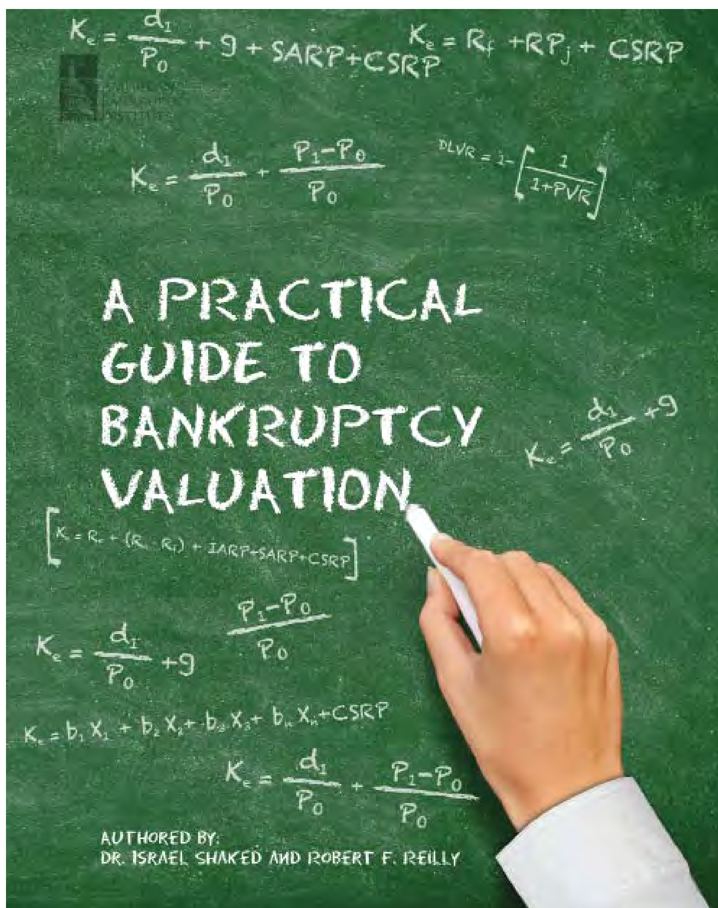

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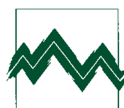

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A PRACTICAL GUIDE TO BANKRUPTCY VALUATION

Dr. Israel Shaked and Robert F. Reilly

Table of Contents

Chapter 1: Business and Securities Valuation Issues

A. Valuation of Closely Held Debtor Company Stock
B. Guideline Company Valuation Methodology: Details Often Overlooked
C. Analysis of Company-Specific Risk in the Bankruptcy Business Valuation
D. Understanding Fair Market Value in Bankruptcy
E. Ten Elements of the Bankruptcy Business Valuation Assignment
F. Playing the Market (Approach): Going Beyond the DCF Valuation Method
G. Valuation of Health Care or Pharmaceutical Companies for Bankruptcy Purposes
H. Valuation Adjustments in the Bankruptcy Business Valuation
I. Liquidity and Control: Valuation Discounts and Premiums and the Debtor Company
J. Quantifying the Valuation Discount for Lack of Voting Rights and Premium for Voting Rights
K. The Use of M&A Transactions in Bankruptcy Valuations: Reasons Why Acquirers Overpay
L. Solvency Analysis: A Primer on Applying the Discounted Cash Flow Method
M. Valuing the Financially Distressed Company
N. Case Studies in Corporate Bankruptcy Valuation

Chapter 2: Tax and Accounting Valuation Issues

A. Income Tax Discharge Considerations in Chapter 7
B. Accounting Rules for Troubled-Debt Restructurings
C. Earnings: Quality vs. Quantity
D. An Offer in Compromise May Offer Tax Relief to Financially Troubled Taxpayers
E. Income Tax Implications of Industrial and Commercial Property Mortgage Debt Restructuring
F. Tax Planning Opportunities Related to the COD Income Deferral Election
G. Worthless Security Deduction for Intercompany Debt to a Financially Troubled Subsidiary
H. Income Tax Issues Related to S Corporation Debt Restructuring

Chapter 3: Financial Advisory Services, External Conditions and Valuation Issues

A. What Drives Companies from Solvency to Distress? Seven Common Causal Factors
B. The Financial Crisis and a Framework for Analyzing the Financially Distressed Company
C. Fraudulent Transfers and the Balance Sheet Test
D. The Independent Investor Test in Shareholder/Executive Compensation Analyses
E. Fiduciary Responsibility in the Case of Defined Contribution Plans
F. The Paradox of Corporate Bankruptcy in a Robust Economy
G. Fraudulent Transfer Considerations Related to the Closely Held Practice Asset Protection Plan
H. Debtor Beware: Double-Edged Sword of Financial Leverage
I. Procedural Checklist for the Review of Solvency Opinions
J. Capturing the Complexity: The Importance of Financial Analysis in an Asbestos Bankruptcy Filing

Chapter 4: Intangible Asset and Intellectual Property Valuation Issues

A. Defining the Intangible Asset Valuation
B. The Identification of Intangible Assets for Bankruptcy Purposes
C. Valuation of Debtor Company Intellectual Property in a Distressed Economy
D. The Valuation of Intangible Assets for Bankruptcy Purposes
E. Debtor Company Valuation: How Good Is Goodwill?
F. A Guide to Valuation of the Assembled Workforce Intangible Asset
G. Intellectual Property Remaining Useful Life Analysis for Bankruptcy Valuations

Chapter 5: Transactions and Structuring Valuation Issues

A. Like-Kind Exchange Safe Harbor Provisions Due to Bankruptcy or Receivership
B. Structuring the § 363 Sale of the Construction Company in Bankruptcy
C. Structuring the Troubled Company Sale Transaction
D. Partnership Debt Restructuring or Renegotiation: Income Tax Planning Considerations

Chapter 6: Valuation Reporting Issues

A. IP Valuation Reports and Valuation Analysts
B. Valuation Analyst Guidelines Related to Bankruptcy Expert Reports and Testimony
C. Bias in Analyst Recommendations: The Curious Case of Bankrupt Companies
D. Valuation Analyst Ethics Considerations in Bankruptcy Business Valuations
E. Managing Your Expert for a Successful Outcome: The 10 Commandments
F. Attributes of an Effective Intangible Asset Valuation Report

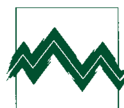
Chapter 7: Real and Personal Property Valuation Issues

A. Valuing a Real Estate Undivided Interest
B. Real Estate Appraisal Report Guidelines
C. Personal Property Appraisal Report Guidelines

Chapter 8: The Bankruptcy Process and Valuation Issues

A. Bankruptcy Valuation Hearings: As Highly Contested as Ever
B. To Be or Not to Be Confirmed: A Debtor's Post-Reorganization Viability
C. Had the Information Been Known: Lessons from the Enron Insolvency
D. The Mirant Valuation Saga: Epic Battle of Experts
D. Summary of Bankruptcy Valuation Issues

Glossary



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The Scrutiny of Executive Compensation

Irina V. Borushko and Lisa H. Tran

The reasonableness of shareholder/employee compensation in a closely held corporation is an important, and often controversial, issue for income tax purposes. Sometimes, owner/executive compensation may be disguised as a management fee, consulting fee, bonus, or "catch-up" payment. In whatever form the executive compensation is reported, closely held company owners often rely on valuation analysts to help them estimate a reasonable level of executive compensation in order to minimize the risk of being audited by the Internal Revenue Service. This discussion (1) reviews federal statutes and judicial precedent regarding reasonable compensation and (2) summarizes some of the owner/executive compensation issues from recent judicial decisions.

Introduction

Internal Revenue Code Section 162(a) allows expenses incurred or paid by a business in a taxable year that include reasonable compensation for services rendered to be deducted for U.S. federal income tax purposes.

If the business is a closely held corporation and the persons receiving the compensation are shareholders, the payments (which may include a salary, bonus, or other compensation paid to shareholder employees) may be subject to close scrutiny by the Internal Revenue Service (the "Service").

The Service may want to determine if the expense represents:

1. market based compensation for services rendered or
2. a disguised distribution of profits to shareholders.

There can be significant tax-related consequences associated with unreasonable shareholder/employee compensation.

In some cases where the shareholder(s) owns several related businesses, the executive compensation is presented in the form of a management fee that one entity charges to another related entity for consulting services provided by the shareholder(s).

This form of compensation issue arose in the case of *F-Star Property Management, Inc. v. Commissioner*.[1] In that decision, the Service disallowed some of the deduction for management fees comprised of compensation paid to the sole shareholder of the corporation. This issue also arose in the case in *Mulcahy, Pauritsch, Salvador & Co. v. Commissioner*.[2] In that decision, the court disallowed a deduction for consulting fees paid indirectly to the founding shareholders, in addition to their salary.

Whether executive pay is reported as compensation expense, or disguised as a management fee, consulting fee, bonus, or "catch-up" payment paid to shareholder employees, to minimize the risk of being audited by the Service, closely held company owners often rely on analysts to help them estimate a reasonable level of executive compensation.

This discussion presents the following:

1. The guidance from the federal tax statutes and judicial precedent on reasonable compensation
2. A review of the judicial decisions in the *F-Star Property Management* case and the *Mulcahy, Pauritsch, Salvador* case regarding compensation from related entities
3. Other owner/executive compensation issues discussed in recent judicial decisions

Reasonable Compensation Guidance

Compensation paid to shareholder executives is often scrutinized by the Service. Shareholder executives of closely held C corporations have an incentive to pay themselves higher salaries in order to avoid paying federal income taxes on the operating profit of the C corporations. Additionally, the Service often claims that excess compensation represents a disguised nondeductible dividend to the shareholder.

Section 162(a) provides that executive compensation is deductible as a business expense if it is (1) reasonable in amount and (2) based on services actually rendered.[3]

For shareholder/executive compensation to qualify as employee compensation, Treasury Regulation 1.162.7 lists the following four requirements. Shareholder/executive compensation should be:

1. an ordinary and necessary expense,
2. reasonable in amount,
3. based on services actually rendered, and
4. actually paid or incurred by the taxpayer corporation.[4]

Also according to Regulation 1.162-7, a taxpayer corporation may deduct a shareholder compensation payment that is based on performance using a percentage formula. Shareholder compensation based on the percentage formula may be:

1. a percent of corporation revenue,
2. a percent of corporation earnings, or
3. a percent of some of corporation income measure.

In addition to federal regulations on executive compensation, companies can also review judicial precedents to determine the reasonableness of executive compensation. Factors to consider in determining the reasonableness of an executive compensation were first presented by the Tax Court 65 years ago in the *Mayson Manufacturing Company v. Commissioner* decision.[5]

The *Mayson* decision listed eight factors that should be evaluated in determining the reasonableness of compensation paid to a shareholder executive.

In 1996, the Tax Court expanded the *Mayson* factors in *Pulsar Components International, Inc. v. Commissioner*,[6] to include the following:

1. The employee's qualifications
2. The nature, extent, and scope of the employee's work
3. The size and complexities of the employer's business
4. A comparison of salaries paid with the employer's gross and net income
5. The prevailing general economic conditions and the background of the industry
6. A comparison of salaries with distributions to officers and retained earnings and the employer's dividend history
7. The prevailing rates of compensation for comparable positions in comparable concerns
8. The salary policy of the employer as to all employees
9. The amount of compensation paid to the particular employee in previous years
10. The employer's financial condition
11. Whether the employer and employee dealt at arm's length
12. Whether the employee guaranteed the employer's debt
13. Whether the employer offered a pension plan or profit-sharing plan to its employees
14. Whether the employee was reimbursed by the employer for business expenses that the employee paid personally

In the *Trucks, Inc. v. U.S.* decision,[7] some of the factors considered regarding the shareholder employee in determining the reasonableness of executive compensation, included the following:

1. Training and qualifications
2. Responsibilities and number of hours worked
3. Results of employee's efforts
4. Ratio of compensation to company growth (before salaries and tax)
5. Absence of fringe benefits available to executives in comparable companies
6. Responsibility for inception and/or success
7. Correlation between compensation and ownership interest

Additionally, the federal courts have increasingly relied on the independent investor test in reasonable compensation disputes. The Tax Court first illustrated the independent investor test in 1984 in the *Elliotts, Inc. v. Commissioner*[8] decision.

In the independent investor test, the Tax Court considered whether an independent investor would pay the shareholder executive the same

compensation he/she was receiving from the company.

The court based its independent investor consideration on the actual rate of return on owner's equity for the subject company compared to a market-derived required rate of return on owner's equity.

The following discussion summarizes judicial decisions relating to:

1. shareholder employee compensation from related entities in the form of a management or consulting fee and
2. other shareholder executive compensation issues from recent court rulings.

Compensation from Related Entities

F-Star Property Management

In *F-Star Property Management, Inc. v. Commissioner*, the court considered the issue of shareholder executive compensation reported as a management fee.

Gerald Ayoub owns a group of related entities collectively known as Five Star Development. Five Star Development purchases land, develops the land into commercial warehouses or retail space, and leases and manages the retail space.

Included in Five Star Development are the following entities:

1. F-Star Property Management, Inc. ("F-Star Management")
2. F-Star Management, LLC, a disregarded entity for tax purposes
3. F-Star Development, L.P., a limited partnership
4. The developed real property limited partnerships

A C corporation located in Scottsdale, Arizona, F-Star Management operates and manages over seven million square feet of commercial rental real estate.

Ayoub owns 100 percent of F-Star Management, 99 percent of F-Star Development, and 99 percent of the developed real property limited partnerships. F-Star Management owns 1 percent of F-Star Development and 1 percent of the developed real property limited partnerships.

F-Star Management (i.e., Ayoub) manages the developed properties. Ayoub is the chief executive officer (CEO) of F-Star Management.

In 2004 and 2005, F-Star Management paid $1,146,279 and $1,197,957, respectively, to Ayoub in the form of a management fee for consulting services rendered. F-Star Management reported taxable income of zero in its 2004 income tax returns and a loss in its 2005 income tax returns.

Upon review of the general ledger of F-Star Management, the Service could not determine how the management fees were paid out. Further, the Service could not reconcile the employee leasing expense on the income tax returns of the development company and the management company.

F-Star Management charges a 4.5 percent monthly management fee on the rent it collects from all the commercial rental properties that it manages for Ayoub. It then pays Ayoub as CEO the 4.5 percent management fee for services Ayoub provided to F-Star Management.

In addition, F-Star Management also employs various other employees to conduct business operations at the corporate headquarters in El Paso, Texas, and Scottsdale, Arizona.

Ayoub's representative described Ayoub's job responsibilities as:

> owner and CEO of the group of companies known as Five Star Development. Ayoub is involved in all aspects of each company within the group. His duties consist of development of investment (real estate) opportunities, review and supervision of day to day operations, coordination of company financial activities, negotiation of business points on contracts, leasing of various buildings and overall supervision of construction projects.[9]

In addition, Ayoub owns 42 percent of Southwest Food Processing and Refrigeration Services, Inc., which paid Ayoub a salary of $186,333 in 2004 and $44,500 in 2005.

The Service argued that the management fees paid to Ayoub in 2004 and 2005 cannot be deductible expenses based on the following reasons:

- Ayoub is the sole shareholder of F-Star Management. Instead of being paid a reasonable salary as a corporate officer, F-Star Management paid Ayoub a management fee.
- F-Star Management asserted that it operates and manages commercial rental real estate. Yet, it described the services provided by Ayoub as the "development of investment (real estate) opportunities," a service that F-Star Management does not provide.

- F-Star Management did not have a formal contract or any documentation to support the payments made to Ayoub. Further, the Service argued that there was no documentation to show how the management fees paid to Ayoub were determined.
- Ayoub as CEO should not receive the 4.5 percent management fee that F-Star Management charged to its rental properties since F-Star Management already employs various employees to manage the properties.

However, the Service did allow a portion of the management fee to be paid as a reasonable salary for Ayoub and reclassified the rest of the management fee as a distribution of profits.

Based on the median salary of a top commercial real estate executive in Phoenix, Arizona, published on Salary.com, the Service determined that a reasonable salary for Ayoub was $200,468.

Since Ayoub already received a salary of $186,333 in 2004 from Southwest Food Processing and Refrigeration Services, Inc., a related entity, the Service allowed the deduction of $14,135 as an additional expense for a total salary of $200,468 for Ayoub.

The Service allowed the deduction of $155,968 for a total salary of $200,468 for Ayoub in 2005 since he already received $44,500 from Southwest Food Processing and Refrigeration Services, Inc.

On November 10, 2008, F-Star Management filed a petition with the U.S. Tax Court. Around January 14, 2009, the F-Star Development case was referred to the Appeals Court for consideration.

Based on the personal income tax returns of Mr. and Mrs. Ayoub, the Ayoubs reported receiving $916,850 of the $1,146,279 accrued management fee in 2004 and $586,503 of the $1,197,957 accrued fee for 2005. Given Ayoub's experience and involvement in the many real estate ventures of his F-Star companies, the Appeals Court believed the amounts received by Mr. and Mrs. Ayoub in 2004 and 2005 were reasonable.

Since Section 267 limits the corporate tax deduction to the amounts actually received and reported, the Appeals Court denied F-Star Management the deduction of $229,429 in 2004 and $611,454 in 2005. The Appeals Court recommended the Service partially abate the income tax deficiencies of F-Star Management in 2004 and 2005.

Section 7430(a)(1) authorizes an award to the prevailing party of reasonable administrative costs incurred in connection with an administrative proceeding with the Service.[10]

The Appeals Court then denied F-Star Management's request for administrative fees since the Service was justified in its position of denying the deduction of management fees even though the Service had partially conceded some of the deductions.

Mulcahy, Pauritsch, Salvador & Co.

Similar to *F-Star Property Management, Inc. v. Commissioner*, in *Mulcahy, Pauritsch, Salvador & Co. v. Commissioner*, the court deliberated on the issue of distributions disguised as third-party consulting fees from related entities.

The company, a professional services firm, paid consulting fees to entities owned by its founding shareholders. The court held that the consulting fees were disguised nondeductible dividends, rather than deductible reasonable salaries for services actually rendered.

Independent Investor Test

The court ruled that deductible owner-employee salary and nondeductible dividend can be distinguished by comparing the corporation's reported income with that of similar corporations.[11] This comparison can be made based on a percentage return on equity.

A higher return provides stronger support that the owner-employee deserves significant credit for the company's increased profitability, which would be reflected in his salary.

The court used the independent investor test to determine the reasonableness of the salary paid to the founding shareholder employees.

An independent investor would be willing to pay a salary to an executive that is a function of:

1. the expected return he/she would demand for his/her investment and
2. the actual return on investment after all expenses, including compensation.

If paying a particular salary causes net income to fall below the investor's expected return, it is unlikely that an independent investor would approve such compensation. However, if earnings after compensation remain at a level acceptable to an investor, it is an indication that management is providing compensable services.[12]

Typically, the higher the rate of return an employee can generate, the greater the salary he/she can command.[13]

The court concluded that an independent investor would not begrudge the owner/employee his high

“The taxpayer should be able to explain why the owner/employee is responsible for any excess earnings of the company.”

salary if the company’s return on equity is satisfactory. He/she would “consider the salary reasonable compensation of the owner’s contribution to the company’s success.”[14] However, the company’s success may also be the result of extraneous factors.

Although the company’s superior performance may be the result of the owner/employee’s contribution, it may also be due to:

1. favorable market conditions,
2. a competitor’s failures,
3. the company’s intangible assets and intellectual property, or
4. being in the right place at the right time.

The taxpayer should be able to explain why the owner/employee is responsible for any excess earnings of the company.

An independent investor may be willing to accept a lower rate of return due to the subject company’s significant sales growth, stability, leverage, and the associated risk of an investment in the company’s equity. An independent investor would consider whether a shareholder employee was instrumental in the financial success and stability of the company.[15]

Additionally, the company’s profitability can be persuasive in an independent investor test when it can be attributed to the proven capability and efforts of the shareholder employee.

When it is possible that the company’s success may be the result of other extraneous causes, other factors such as comparable salaries should be considered to determine reasonable compensation. In this particular decision, the court compared the salaries in question to those of comparable employees (employees with similar duties, responsibilities, and skills) of other companies who are not owners, or to nonowner employees of the company itself, who make comparable contributions to the company’s success.

The court considered the company’s general economic and financial condition, stating that “when a thriving firm that has nontrivial capital reports no corporate income, it is apparent that the firm is understating its tax liability.”[16]

Additionally, because the company was a professional services firm, with revenue that is closely tied to the services performed by its employees, the court examined the number of employees at the company, its intangible and tangible capital, and its equity ownership.

Services Rendered

Additionally, the Tax Court emphasized that there should be evidence that consulting fees are compensation for actual consulting services rendered by the shareholder employees.

The owner employee’s contribution of capital to the company is not considered a “personal service” for which the owner may be reimbursed by means of a deductible salary.

In this case, in addition to receiving salaries for their revenue-generating services, the shareholder employees also received consulting fees that the company paid to the entities owned by the same shareholder employees. These entities in turn passed the money on to the shareholders.

The company owners treated these consulting fees as salary, thus reducing the company’s income and return to equity investors. However, based on earnings before the deduction for consulting fees, the company was performing well.

The company owners argued that the consulting fees paid to related entities were not payments for services rendered to the company by these entities. The company argued that these consulting fees represented payments for accounting and consulting services provided by the founding shareholders to the company’s clients, and were in effect an additional salary.

However, the court did not find any evidence that showed the consulting fees were compensation for actual accounting and consulting services rendered by the founding shareholders. The company did not treat the consulting fees as labor expenses and did not withhold payroll taxes on them.

The amounts were not reported as employee compensation on employment forms and were not disclosed in the officers’ compensation schedule in the corporate income tax returns. There was no record that matched consulting fees to work performed by each shareholder.

Ruling

The Tax Court also found that the company estimated its own tax liability and decided to classify the consulting fees as salary without seeking independent tax advice, thus, creating a conflict of interest.

The court concluded that the consulting fees were not deductible and were in effect distributions

to the shareholders. In conclusion, the court found the taxpayer liable for a statutory penalty for substantial underpayment of income taxes.

Other Judicial Guidance

Aries Communications Inc. v. Commissioner

In Aries Communications Inc. v. Commissioner,[17] the Tax Court considered the reasonableness of compensation paid to the corporation's owner/employee. In particular, the court considered the appropriateness of a sales bonus and "catch-up" payments made to the owner as part of his compensation.

The owner/employee was the corporation's president, chief financial officer (CFO), and sole shareholder from its incorporation. He was actively involved in the day-to-day operations of the corporation.

Additionally, when the corporation was seeking to sell some of its assets, the owner referred potential purchasers for the sale of two of its radio stations, and was personally involved in garnering the first bids and subsequent negotiations.

The owner's compensation package included a base salary, commissions, and two significant bonuses made in the years of the two asset sales. The compensation package included payments for previously uncompensated work and a bonus based on the substantial income he generated from the sale of the two radio stations.

The Tax Court considered the reasonableness of the compensation, and in particular, the bonuses, in light of the following five factors:

1. Employee's role in the company
2. Comparison of employee's salary with salaries paid by similar companies for similar services
3. Character and condition of the company
4. Potential conflicts of interest
5. Internal consistency

The court also considered whether an independent investor would be willing to compensate the employee as the taxpayer did.

Owner's Role

To assess the reasonableness of his compensation, the Tax Court considered the company's reliance on the owner/employee. Other relevant considerations included his position, hours worked, and duties performed, as well as tenure and experience in the industry. The owner was the most valuable employee of the company. Additionally, the owner provided a personal guarantee for company debt.

The court considered the argument that the owner employee was entitled to a bonus for the asset sales, which he "masterminded" and facilitated.

In some circumstances, "the value of an outstanding achievement cannot readily be quantified."[18] Experts that testified disagreed on how to quantify the owner's contribution to the sale of assets.

With respect to the bonuses paid, the court considered the worth of the owner's services in the sale of the assets, assuming the owner acted as a consultant to improve the sale offers. Additionally, the court considered whether executive bonuses at similar companies increased in correlation to increasing receipts of the company.

The owner made the decision to both acquire and maintain the assets sold, which appreciated significantly. The court considered whether he:

1. invested in the assets personally as a passive owner/investor or
2. made the investment choices as a money-making strategy in his capacity as the chief executive officer.

Had he personally purchased the assets and then transferred them to the corporate entity, the deduction of compensation, or bonus, for the sale of such assets would be disallowed.

However, the assets were acquired by the company, and the decisions of the owner were treated as the decisions of the CEO of the company. The owner in his executive capacity played a pivotal role in the acquisition, management, and profitable sale of the company's major assets. His efforts over the years allowed the company to capitalize on this business opportunity.

The Tax Court argued that the owner had significant interest in garnering the highest price for the assets in order to receive the reward in the form of a salary deductible by the corporation, rather than as a nondeductible dividend.

The court determined that despite this fact, his efforts as an employee were still entitled to a reasonable compensation for the services actually rendered. Given his dual status as a shareholder and CEO, he would in all events be motivated to obtain the highest sale price.

Catch-up Pay

The Tax Court also considered the taxpayer's claim that the owner's compensation was reasonable

because it included catch-up payments for prior years in which the owner was undercompensated.

Occasionally, the compensation in dispute may include deferred compensation that was paid years after it was earned. “Catch-up pay is especially common when start-ups cannot pay the founders the full value of their services because of limited cash flow[,] yet these early years may be when the owners worked the hardest.”[19]

Companies may not have the resources to pay shareholder employees reasonable compensation in growth years, as they may be generating lower margins or retaining capital for corporate investment.

Once the company determines that it can sustain a higher reasonable level of compensation, they may award higher pay to retroactively remunerate the shareholder employee for lower compensation during the growth or start-up years.

In various circumstances, the Service has allowed higher than average levels of compensation to be deductible for companies that maintained records and effectively demonstrated that the shareholders were purposely awarded higher compensation to make up for past inequity.[20]

However, if the shareholder employee’s past services have not been well documented and undercompensation cannot be effectively demonstrated, it may be difficult to determine whether any portion of compensation (and how much) is for actual catch-up pay.

Compensation in the years in which the shareholder claims to have been undercompensated may be compared with the compensation of comparable positions at guideline companies.

According to the court, compensation for prior years’ services is deductible in the current year as long as the employee was actually undercompensated in prior years, and the current payments are intended to compensate for prior services. Based on expert witness findings, the court found that the owner’s salary was below market level in prior years, and some catch-up compensation was appropriate.

Condition of the Company

In assessing the reasonableness of executive compensation, the court also analyzed the character and condition of the company. The court focused on company size, complexity, net income, and its general economic condition. The court considered the company’s capital structure and its level of leverage.

The Tax Court also considered the company’s ability to operate as a going concern, had the sale of its assets not occurred. The assets that were sold appreciated significantly in value since their acquisition, presumably based on the future cash flow they were expected to generate.

The court compared the actual financial performance of the company to the expected performance of the company from the effective use of these assets. The court found that the company’s actual performance was below the company’s expected performance using the assets.

Conflict of Interest

The court also considered any indicia of a conflict of interest. The court is concerned that when there is a relationship between an owner employee and the company, this may allow the owner employee to disguise nondeductible corporate distributions as salary expenditures.[21]

Close scrutiny is warranted when the shareholder employee has control of the corporation, serves on the board of directors, or is a trustee for the company’s retirement plan.

The court determined that a relationship did exist between the corporation and the employee owner because the number of shares of common stock outstanding had changed, and this could not be reconciled with the company’s retained earnings.

The change in shares outstanding would imply that some distribution to stockholders may have occurred, although there was no documentation of any dividend distributions.

However, the court ruled that “the mere existence of such a relationship, when coupled with the absence of dividend payments, does not necessarily lead to the conclusion that the amount of compensation is unreasonably high.”[22]

In such case, the alleged salary payments may be closely scrutinized, and compensation may be evaluated from the perspective of a hypothetical independent investor.

The owner employee facilitated the sale of assets for prices much higher than initially offered and kept the company out of bankruptcy by paying off the company’s debt with the proceeds. Similarly, an independent investor would seek the highest price for company assets and would reward any employees for their work in securing such prices.

The owner also had a “significant interest in garnering the highest price for the assets and then receiving the reward [for the sale] as salary deductible [bonus] instead of a nondeductible dividend.”[23]

The court also considered other conflicts of interest that existed between the owner and the company. The corporation argued that the owner/employee’s investment in and maintenance of the assets, not just his negotiation skills, contributed

to the profitable sale of the assets. The corporation argued that the owner employee should be reimbursed for this work. The court found that the owner employee was already well compensated for his work in investing in and maintaining the assets of the company, before consideration of the bonus.

Additionally, the owner/employee received significant financial benefit from the loans made to him by the company.

Internal Consistency

The court also looked at any internal consistency issues within the company, considering existing company policies regarding compensation and bonuses and how consistently these policies are applied. "Evidence of an internal inconsistency in a company's treatment of payments to employees may indicate that the payments go beyond reasonable compensation."[24]

The Service scrutinizes executive bonuses that have not been awarded under a structured, formal, and consistently applied performance bonus program. In this case, the bonuses paid to the owner employee were not paid under a structured or formal plan.

In contrast, "evidence of a reasonable, longstanding, consistently applied compensation plan is evidence that the compensation paid in the years in question is reasonable."[25]

Bonuses paid under a taxpayer's plan to award (1) additional compensation for present work or (2) reimbursement for prior years' lack of compensation once the company becomes profitable may be allowable.

With regard to the bonuses, the court considered whether the taxpayer's profits and potential federal income tax liability were known at the time the bonuses were determined. If the salary or bonus is determined at the end of the fiscal year when the company profitability is known, the shareholder employee may have an incentive to set his/her compensation at a higher level to minimize the corporate tax liability and disguise a dividend as compensation.

Additionally, the court compared the owner/employee compensation with that of other employees of the company.

Independent Investor Test

Next, the Tax Court determined the reasonableness of the compensation from the viewpoint of an independent investor. An investor would expect to receive a return on initial investment and "would not approve of a salary package that depleted the corporation's assets without paying the investor."[26]

The taxpayer claimed that owner's compensation included "catch-up" payments for prior services rendered. However, if the majority of the corporate earnings are paid out as compensation so that corporate profits after payment do not represent a reasonable return on equity, an independent investor would probably disapprove of such a compensation arrangement.

". . . evidence of a reasonable, longstanding, consistently applied compensation plan is evidence that the compensation paid in the years in question is reasonable."

In contrast, if the earnings on equity remain at a satisfactory level to an independent investor, this would indicate that management is providing compensable services and that profits are not being taken out of the company disguised as salary.

The court determined that return on investment acceptable to an independent investor was in the range of 10 to 20 percent, an indication that compensation is reasonable.[27]

Ruling

In *Aries Communications Inc. v. Commissioner*,[28] the Tax Court concluded that the owner/employee compensation was high in comparison to salaries paid by similar companies and that the owner/employee had a significant interest in garnering the highest price for the assets, in order to receive a reward in the form of a salary deductible by the corporation rather than a nondeductible dividend.

The court also found that the owner's fixed salary was underpaid and some "catch-up" compensation was appropriate. Further, the court determined that a partial bonus for the sale of assets was appropriate.

K&K Veterinary Supply, Inc. v. Commissioner

In *K&K Veterinary Supply, Inc. v. Commissioner*, the court reviewed (1) the employee's qualifications and performance and (2) the compensation of similar positions in comparable companies to determine the reasonableness of executive compensation.

The company, a wholesale distributor of animal health products, was founded by John Lipsmeyer ("J. Lipsmeyer") and Kelly Bright.

J. Lipsmeyer was the company's sole shareholder, president, and co-chief executive officer and co-chief operating officer with his brother, David Lipsmeyer ("D. Lipsmeyer"). J Lipsmeyer's wife,

Melissa Lipsmeyer ("M. Lipsmeyer") was the vice president, secretary, and assistant CFO. His daughter, Jennifer Stewart ("Stewart") was the company's CFO. J. Lipsmeyer and M. Lipsmeyer were the coguarantors of the company's line of credit.

The company paid compensation to J. and M. Lipsmeyer as officers and to D. Lipsmeyer and Stewart as employees. Additionally, J. Lipsmeyer received a dividend of $30,000 in each of the years at issue (2006 and 2007). The Service disallowed a portion of the (1) officer's compensation paid to J. and M. Lipsmeyer and (2) salaries and wages paid to D. Lipsmeyer and Stewart.

Shareholder Employee Factors

In this case, the Tax Court considered factors such as the nature, extent, and scope of the work performed by the shareholder employee to determine if the company's success was due to the employee or the result of other extraneous factors.

The court also considered the size and complexity of the company, as well as the general economic conditions, which may affect the performance of a company. "Adverse economic conditions . . . tend to show that an employee's skill was important to a company that grew during the bad years."[29]

The court analyzed compensation as a percentage of the corporation's gross and net income to determine its reasonableness. The court reasoned that higher percentages may be warranted if:

1. the shareholder executives are exceptionally qualified by virtue of education, training, experience, dedication, and have been undercompensated in previous years;
2. the shareholders' training, experience, and dedication was the primary reason for the company's growth and success;
3. the shareholder executives' services led to the company's success; or
4. evidence exists that profits are attributable to the shareholder executives.[30]

Internal Comparison

The court considered internal consistency issues, examining the company's compensation policy for other employees, and whether the company compensates all employees, both shareholders and nonshareholders, at "top dollar." The court also considered whether the company paid any dividends.

The company had an employee handbook, which stated that salary would be determined by the company's president. The handbook did not include a written bonus policy.

Bonuses were paid based on the company's financial performance, employee job performance, and work ethic. The company paid dividends to J. Lipsmeyer in 2006 and 2007.

The shareholder employee compensation was compared to (1) distributions made to shareholders, (2) compensation paid to nonshareholder employees, and (3) compensation paid to the shareholder employee in previous years when the company had a limited number of officers.

Guideline Company Comparison

The Tax Court opined that comparison of compensation to the prevailing rates of compensation paid to employees in similar positions in comparable companies within the same industry is the most significant factor in determining whether compensation is reasonable.[31]

This comparison may include an analysis of (1) the actual industry-based compensation based on job titles and responsibilities or (2) financial ratios based on the compensation compared to sales, profit, assets, or other measures for the subject company and comparable companies.

All forms of compensation paid by guideline companies should be considered, including the following:

1. Salary and bonus
2. Stock and stock options
3. Use of company assets
4. Other benefits

Courts have recognized that employees performing a greater number of responsibilities should be paid a higher compensation. However, "stacking" should not be used. This means that compensation of a full-time CEO and the compensation of a full-time CFO should not be added together.

This is because it is challenging for one person to perform all the job responsibilities of two senior executives in a 40 to 60 hour work week. It may be more appropriate to determine market-based compensation for the higher paying position and increase it by a reasonable allowance.[32]

The Tax Court concluded that although the officers (1) were highly qualified for their positions, (2) had worked for the taxpayer corporation since its incorporation, and (3) were significantly involved with the taxpayer corporation's successful operations, their compensation was too high compared to the taxpayer corporation's gross and net income, as well as compared to compensation of similar positions at comparable companies.

Conclusion

The reasonableness of shareholder employee compensation in a closely held corporation is an important, and often controversial, issue for income tax purposes. Compensation that is considered reasonable by the corporate taxpayer is frequently considered unreasonable by the Service.

This is because a shareholder executive is often motivated to deviate from arm's-length compensation in order to minimize the income tax expense of the corporation.

The Service is concerned that excess owner/employee compensation (1) absorbs taxable corporate income and (2) represents a disguised nondeductible dividend to the shareholder. Excess owner/employee compensation may be disguised as a management fee or a consulting fee from related entities.

Additionally, a corporate taxpayer may attempt to deduct excess shareholder employee compensation in the form of bonuses and catch-up payments for previously rendered services.

The tax consequences associated with unreasonable compensation may be significant. The taxpayer bears the burden of proof that the reasonable compensation determination by the Service is incorrect.

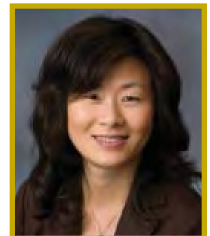
Determining the reasonableness of shareholder employee compensation can be a challenging task. Over the years, the Service and the courts have developed numerous guidelines to enable corporate tax payers and their consultants (i.e., valuation analysts) to determine the reasonableness of shareholder employee compensation.

In whatever form the executive pay is reported, closely held companies should rely on valuation analysts to help them estimate a reasonable level of executive compensation in order to minimize the risk of being audited by the Service.

When performing a reasonable compensation analysis, it is important for the analyst to review federal statutes regarding reasonable compensation, and the factors and methods that the Service and courts have considered in their assessment of reasonable executive compensation in prior court cases.

Notes:

1. F-Star Property Management, Inc. v. Commissioner, T.C. Memo. 2013-6 (January 10, 2013).
2. Mulcahy, Pauritsch, Salvador & Co. v. Commissioner, 680 F.3d 867 (May 17, 2012).
3. Internal Revenue Code Section 162(a)(1).
4. Treasury Regulation 1.162-7.
5. Mayson Manufacturing Co. v. Commissioner, 178 F.2d 115 (6th Cir. 1949).
6. Pulsar Components International, Inc. v. Commissioner, T.C. Memo. 1996-129 (Mar. 14, 1996).
7. Trucks, Inc. v. U.S., 588 F. Supp. 638 (D.C. Neb. 1984).
8. Elliotts, Inc. v. Commissioner, T.C. Memo. 1984-516 (Sept. 27, 1984).
9. F-Star Property Management, Inc. v. Commissioner, T.C. Memo. 2013-6 at *4 (January 10, 2013).
10. Id. at *12.
11. Mulcahy, Pauritsch, Salvador & Co. v. Commissioner, 680 F.3d 867, 869 (May 17, 2012).
12. Elliotts, Inc., T.C. Memo. 1984-516.
13. Exacto Spring Corporation v. Commissioner, 196 F.3d 833, 838 (7th Cir. 1999).
14. Mulcahy, Pauritsch, Salvador & Co., 680 F.3d at 871.
15. Multi-Pak Corporation v Commissioner, T.C. Memo. 2010-139 (June 22, 2010).
16. Mulcahy, Pauritsch, Salvador & Co., 680 F.3d at 874.
17. Aries Communications Inc. & Subs. v. Commissioner, T.C. Memo. 2013-97 (April 10, 2013).
18. Stephen Kirkland, "Normalizing Owner's Compensation in Business Valuations," *The Value Examiner* (September/October 2013).
19. Ibid.
20. Adam Minow, "A Shareholder-Employees' Guide to Determining Their Worth," *California CPA Magazine* (January/February 2012).
21. Aries Communications Inc. & Subs., T.C. Memo. 2013-97 at *12.
22. Id. at *13.
23. Id.
24. Id. at *14.
25. Id.
26. Id. at *15.
27. Id.
28. K&K Veterinary Supply, Inc. v. Commissioner, T.C. Memo 2013-84 (March 25, 2013).
29. Id. at *6.
30. Id. at *7.
31. Id.
32. Kirkland, "Normalizing Owner's Compensation in Business Valuations."



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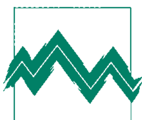

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A Review of BMC Software, Inc. v. Commissioner of Internal Revenue: Should Intercompany Accounts Receivable Be Considered "Debt"?

Samuel S. Nicholls

The matter of BMC Software, Inc. v. Commissioner, *tried before the U.S. Tax Court, involved (1) the BMC repatriation of foreign funds through the Internal Revenue Code Section 965 repatriation tax holiday and (2) the subsequent distinction between related-party accounts receivable and related-party debt that resulted from a 2007 transfer pricing settlement between BMC and the Internal Revenue Service. This discussion (1) describes the facts of the case, (2) explains the Tax Court's reasoning behind its decisions, and (3) concludes with commentary on the unanswered questions raised as a result of this case.*

Introduction

In the matter of *BMC Software, Inc.* ("*BMC*") *v. Commissioner*,[1] the U.S. Tax Court (the "Tax Court") ruled on the definition of "debt" as it relates to intercompany indebtedness between a U.S. taxpayer and its foreign subsidiary.

At issue in this decision was the BMC accounts receivable owed from its foreign subsidiary, BMC Software European Holding (BSEH). This accounts receivable was created as a result of a transfer pricing settlement between BMC and the Internal Revenue Service (the "Service") in 2007.

The specific question in the BMC decision was whether or not this accounts receivable increased the company's related-party indebtedness between October 3, 2004, and March 31, 2006 (the testing period). If it did, then the amount of money that BMC repatriated under the Internal Revenue Code Section 965 tax holiday would be reduced, and BMC would owe additional tax.

That is, if the intercompany accounts receivable were deemed to be debt, then BMC would have overstated its dividends received deduction ("special dividend") and it would have to retroactively pay the regular tax on the amount of the overstatement.

Related-party indebtedness was relevant in this decision, because Section 965 does not permit any increase in related-party indebtedness to be included in the amount of funds eligible for the special dividend.

The testing period is relevant because Congress provided that the amount of the Section 965 special dividend deduction would be reduced by any increase in related-party indebtedness during the "testing period."

The Service took the position that (1) the establishment of the account receivable, resulting from a transfer pricing adjustment in 2007, constituted increased related-party indebtedness, (2) the related-party debt should be applied retroactively to the testing period, and (3) this amount should not be included in the special dividend.

BMC disagreed and petitioned the Tax Court for relief.

The Tax Court filed its opinion on September 18, 2013, ruling in favor of the Service. In its opinion, the Tax Court concluded that some of the

funds repatriated by BMC under Section 965 were ineligible for the special dividend. This is because those funds included an intercompany accounts receivable that the Tax Court considered to be a form of intercompany debt.

BMC subsequently filed an appeal with the U.S. Court of Appeals for the Fifth Circuit (the "Fifth Circuit"), and the case is currently pending review. The Fifth Circuit's decision could have broad implications for intercompany transfer pricing issues.

The Facts of the Matter

BMC is a U.S. corporation that develops and licenses computer software. BSEH is a wholly owned foreign subsidiary of BMC, and is classified as a controlled foreign corporation (CFC) under Section 957.

Section 957 defines a CFC as a non-U.S. corporation whose combined voting power of its stock is over 50 percent owned by a U.S. taxpayer.

Prior to 2002, BMC and BSEH jointly developed software under cost-sharing agreements, which were terminated in 2002. BMC assumed title to the intellectual property and subsequently paid royalties to BSEH.

The dispute in this decision stems from two economic events that occurred between BMC and BSEH.

First, BMC repatriated funds held by BSEH through a Section 965 special dividend. Second, the Service imposed transfer pricing adjustments for royalties paid by BMC to BSEH for the year in which BMC received the special dividend. The Service's adjustment (to both the special dividend year and to other years) gave rise to an accounts receivable between BMC and BSEH.

The ensuing matter hinged on the Tax Court's definition of debt. This is because the Service contended that accounts receivables constitute debt and, therefore, should be excluded from the special dividend calculation pursuant to Section 965(b)(3).

The Tax Court ruled in favor of the Service on September 18, 2013. The taxpayer subsequently appealed to the Fifth Circuit. The taxpayer's appeal is still pending before the Fifth Circuit.

Event #1: BMC's Special Dividend

Section 965 was enacted in 2004 as part of the Jobs Creation Act. It was intended to encourage U.S. corporations to repatriate profits held offshore by foreign subsidiaries, via a special dividend, and to reinvest those funds in the domestic economy.

Section 965 allows for 85 percent of such repatriated earnings to be tax deductible. The repatriation is deemed to take the form of a special dividend, and the amount eligible for the tax deduction may not include any related-party indebtedness.

That is, for purpose of calculating the special dividend, Section 965(b)(3) disallows the inclusion of any increase in related-party indebtedness. This measure was intended to forestall U.S. taxpayers from engaging in debt financed repatriation of earnings that would have otherwise been generated and taxed in the United States.

For its tax year ending March 31, 2006, BMC elected to exercise its right to repatriate funds held by BSEH pursuant to Section 965. For tax year 2006, BMC elected to repatriate $721 million in foreign funds, of which it claimed $709 million as eligible for the special dividend.

In its case before the Tax Court, BMC argued that on the date that it elected to receive the special dividend, there had been no increase in related-party indebtedness during the testing period of October 3, 2004, to March 31, 2006.[2]

Event #2: Transfer Pricing Adjustments

Subsequently, and unrelated to the special dividend, the Service determined that the royalties BMC paid to BSEH between 2003 and 2006 were inflated (i.e., not at arm's length).

This determination led to:

1. the BMC U.S. reported taxable income being understated in those years and

2. Service-imposed transfer pricing adjustments to the BMC taxable income.

Primary Adjustment

A primary adjustment was made to the accounts of BMC and BSEH for the years 2003 to 2006 to reflect arm's-length pricing. These adjustments increased the BMC income by $35 million for 2003, $23 million for 2004, $22 million for 2005, and $22 million for 2006.[3]

These adjustments were effected through a closing agreement between BMC and the Service, executed on August 30, 2007.

A closing agreement is essentially a legally binding, final agreement between the Service and a taxpayer related to a matter. The potential benefit to the taxpayer for engaging in a closing agreement with the Service is that it can provide a permanent resolution to the issue.

Regulation 301.7121-1(a) defines the nature of closing agreements as follows:

> The Commissioner may enter into a written agreement with any person relating to the liability of such person (or of the person or estate for whom he acts) in respect of any internal revenue tax for any taxable period ending prior or subsequent to the date of such agreement. A closing agreement may be entered into in any case in which there appears to be an advantage in having the case permanently and conclusively closed, or if good and sufficient reasons are shown by the taxpayer for desiring a closing agreement and it is determined by the Commissioner that the United States will sustain no disadvantage through consummation of such an agreement.

Secondary Adjustment

A secondary adjustment is required because U.S. taxpayers who have had primary adjustments made to their taxable income under Section 482 should then contend with the accounting treatment of the counterparty (i.e., the foreign subsidiary).

In other words, the foreign subsidiary's financial statements need to be adjusted to properly reflect the adjustments made to the U.S. taxpayer's financial statements.

These secondary adjustments amend the parties' balance sheet accounts. The BMC secondary adjustments related to transactions between BMC and BSEH for the years 2003 to 2006, and were effected through another closing agreement between BMC and the Service, executed on August 30, 2007.

The secondary adjustments to square the accounts between BMC and BSEH were achieved through the establishment of accounts receivable for the years 2003 to 2006, owed by BSEH to BMC, on a tax-free basis.[4]

Unless the taxpayer elects to exercise its privileges under Revenue Procedure 99-32,[5] the secondary adjustments to "square the ledger" between party and counterparty are treated as dividends or capital contributions for U.S. tax purposes and are subject to withholding tax.[6]

Revenue Procedure 99-32 was created to provide relief from this collateral tax effect. Under Revenue Procedure 99-32, the secondary adjustments may be accomplished through the establishment of accounts receivable, in the amount of the transfer pricing adjustments, on a tax-free basis.

The secondary adjustments closing agreement conclusively established that BMC had elected to conform the accounts through accounts receivable, bearing interest at the applicable federal rate, pursuant to Revenue Procedure 99-32.

The interest was deductible from the BSEH taxable income. BSEH subsequently paid the principle and interest owed within 90 days of the effective date of the secondary adjustments closing agreement.[7]

Mathematical Illustration of the Chain of Events

The relevant chain of events in this case is depicted in Exhibit 1 on the next page. For simplicity and illustrative purposes, the figures presented are hypothetical and unrelated to BMC, and the foreign subsidiary's taxation is omitted.

The Service's Position

The Service argued that the secondary adjustments accounts receivable established in 2007 increased the related-party indebtedness, and, therefore, BMC had taken too large a special dividend in 2006.

Under Section 965(b)(3), the amount of the special dividend should be reduced by the increase in related-party indebtedness unless it is due to the ordinary course of trade.

The Service reduced the amount of BMC's special dividend by $43 million, citing *Bush v. United States*,[8] in which the court opined, "The teaching of these cases is that a closing agreement will not implicitly preclude the imposition of otherwise applicable law. If the parties intend that a law will not apply, they must explicitly agree on that point in the closing agreement."

Exhibit 1
Hypothetical Illustration of the Events Relating to Section 965, 482, and 965(b)(3)

		U.S. Co.		Foreign Sub.
Event 1: Repatriation (Section 965) – assume $2,000				
	Cumulative royalties paid	-	→	2,000
	Section 965 repatriation	2,000	←	(2,000)
Less:	Income shielded (85%)	1,700		
Equals:	Taxable income	300		
Less:	Income tax expense (at 35% tax rate)	105		
Equals:	Ending balance	1,895	[A]	-
Event 2: Transfer price adjustments (Section 482) – assume $500				
	Transfer price adjustment (size of excess royalty)	500	← **via accounts receivable (Rev. Proc. 99-32)**	(500)
Less:	Income tax expense (at 35% tax rate)	175		
Equals:	Ending balance	325	[B]	
	Total ending balance without related party debt reduction	**2,220**	**= [A + B]**	
Event 3: IRS dissalows repatriation of accounts receivable amount (Section 965(b)(3) – related party debt increase)				
	Original repatriation amount	2,000		
	Accounts receivable amount disallowed (Section 965(b)(3))	500		
	Section 965 repatriation – revised	1,500		
Less:	Income shielded (85%)	1,275		
Equals:	Taxable income	225		
Less:	Income tax expense (at 35% tax rate)	79		
Equals:	Ending balance	1,421	[C]	
	Total ending balance with related party debt reduction	**1,746**	**= [B + C]**	

Notes:
- We are viewing the transactions from the Service's perspective, hence taxation by the foreign government is not addressed.
- The figures above are based on a hypothetical example for illustrative purposes, and are not actual figures related to BMC.

The Service added that if BMC had desired that the secondary adjustments closing agreement not classify the accounts receivable as debt, BMC should have indicated so. It also pointed out that BMC had drafted the agreement.

Although the secondary adjustments accounts receivable were formally established in 2007, which was after the testing period observed for compliance with the Section 965(b)(3) special dividend, the Service determined that these secondary adjustments resulted in:

1. an increase in related-party indebtedness and
2. retroactively applied to the testing period.

The Service also contended that the secondary adjustments accounts receivable were not the product of the ordinary course of trade, since they were borne out of transfer pricing adjustments. This is notwithstanding the fact that the transfer pricing adjustments related to the ordinary course of trade royalties between BMC and BSEH.

The Service, therefore, determined that BMC had overstated the Section 965 special dividend by $43 million and issued a deficiency notice for tax year 2006. BMC then petitioned the Tax Court for relief.

Tax Court Opinion (September 18, 2013)

Issues Considered by the Tax Court[9]

Prior to reaching its opinion, the Tax Court stated that it would decide on the following issues:

- Whether the secondary adjustments accounts receivable constituted increased related-party indebtedness for the purposes of Section 965

- Whether the secondary adjustments accounts receivable, that were deemed established during the testing period, should retroactively be taken into account when determining the amount of funds eligible for the Section 965 special dividend
- Whether the parties agreed in the secondary adjustments closing agreement that repayment of the accounts receivable should be free from further taxation

In addition to opining on these issues, the Tax Court also examined other points of contention, specifically the BMC argument that a violation of Section 965(b)(3) requires intent.

Does a Violation of Section 965(b)(3) Require Intent?

The Tax Court examined the BMC assertion that the related-party debt rule (Section 965(b)(3)) applies only if there is an abusive transaction intended to skirt U.S. taxation.

In the Tax Court analysis of statutes pertinent to that and other areas of contention, it asserted that "our principal task when interpreting a statute is to ascertain and give effect to Congress' intent,"[10] and the Tax Court will examine legislative history "to ascertain congressional intent only if a statue is silent or ambiguous."[11]

To decide on this issue, the Tax Court considered the BMC citation of language that Congress added later to Section 965, which conferred to the Service the authority to issue regulations preventing transactions that avoid the statute's purposes.[12]

The Tax Court also considered language contained in a Joint Committee on Taxation explanation that stated, "It is anticipated that dividends would be treated as attributable to a related-party transfer of cash or other property under this authority only in cases in which the transfer is part of an arrangement undertaken with a principal purpose of avoiding the purposes of the related-party debt rule of Section 965(b)(3)."

The Tax Court concluded that Section 965(b)(3) "does not include an intent requirement." In reaching this conclusion, the Tax Court noted that Congress did not amend the operative language of Section 965(b)(3) when it added the aforementioned language, but rather conferred to the Service discretion to add supplemental regulations aimed at preventing circular transactions intended to skirt being classified as indebtedness.

In other words, a taxpayer's intent would be observed, but it would not be the litmus test.

Should Accounts Receivable Be Defined as "Debt"?

The Tax Court turned to dictionary definitions, not finance definitions, to determine the meaning of "debt" as it related to Section 965 and the secondary adjustments accounts receivable. The Tax Court noted, "We may consider dictionary definitions to understand the meaning that Congress may have intended."[13]

It then cited the definition of indebtedness according to *Black's Law Dictionary*, which defines indebtedness as, "the condition or state of owing money" or "something owed; a debt."[14]

The Tax Court acknowledged that the term "account receivable" is defined neither by Revenue Procedure 99-32 nor by the secondary adjustments closing agreement.

The Tax Court thus turned again to *Black's Law Dictionary*, which defines accounts receivable as, "an account reflecting a balance owed by the debtor."[15]

Based on these definitions of debt and accounts receivable, the Tax Court concluded that the BMC secondary adjustments accounts receivable established pursuant to Revenue Procedure 99-32 constituted increased indebtedness.

Should Accounts Receivable Be Considered "Trade Payables" and Be Exempt from the Definition of Debt?

BMC contended that pursuant to Notice 2005-38, the secondary adjustments accounts receivable were actually trade payables, and, therefore, ought to be excluded from the definition of increased indebtedness.

Notice 2005-38 states: "For purposes of section 965(b)(3), the term 'indebtedness' does not include indebtedness arising in the ordinary course of a business from sales, leases, or the rendition of services provided to or for a CFC by a related person, provided that such indebtedness is actually paid within 183 days."[16]

The Service, alternatively, argued that the secondary adjustments accounts receivable were established by the closing agreement, not the course of ordinary business, and were, therefore, not trade related.

The Tax Court held that the accounts receivable were not established in the ordinary course of business, and furthermore were paid more than a year after the time frame for which the accounts receivable were assigned.

Whether the Increased Indebtedness Occurred During the Testing Period

The Tax Court then examined whether the secondary adjustments accounts receivable constituted increased indebtedness during the testing period, despite being established in 2007, after the testing period.

The Service contended that BMC agreed in the secondary adjustments closing agreement that the accounts receivable were deemed established during the testing period.

This was the shortest section of the Tax Court opinion. The Tax Court held that, per the secondary adjustments closing agreement, two of the accounts receivable were deemed established during the testing period.

Additional Income Tax Resulting from the Secondary Adjustments Closing Agreement

BMC argued that, pursuant to the secondary adjustments closing agreement, it should be free of any further federal income tax consequences resulting from the establishment of the accounts receivable, namely those which pertain to the special dividend.

The Tax Court cited *Schering Corp. v. Commissioner*, whereby the closing agreement in that case stated that the accounts receivable was "free of further Federal income tax consequences."[17]

The Tax Court held that the accounts receivable repayment, and not the accounts receivable themselves, was free of further tax consequences and, therefore, ruled that the accounts receivable were deemed established for all federal tax purposes.

The Ruling[18]

The Tax Court issued its opinion on September 18, 2013, and ruled in favor of the Service. The Tax Court concluded that the secondary adjustments accounts receivable "constitute indebtedness for the purposes of Section 965(b)(3)," and were, therefore, disallowed as part of the BMC special dividend.

The Tax Court also concluded that:

1. the related party debt rule is not confined strictly to increased indebtedness resulting from willful abuse of the U.S. Code (i.e., intent was not required) and
2. the accounts receivable were deemed established during the testing period, and, therefore, should retroactively be applied for purposes of determining the special dividend.

Consequences of the Tax Court Decision

The Tax Court decision leaves many issues outstanding for corporate tax professionals and their advisers. These issues relate to the definitions of debt and accounts receivable, the distinction between the reporting of, and the economic reality of, intercompany transactions, and the proper crafting of transfer pricing agreements between taxpayers and the Service.

Even after the *BMC* decision, many transfer pricing issues remain open to interpretation.

The next section of this discussion points out some of the questions that were raised as a result of this Tax Court decision.

Definition of Debt

The Tax Court ultimately relied on *Black's Law Dictionary*[19] for the definition of debt, defined as "the condition of owing money," and the definition of "account receivable" defined as an "account reflecting a balance owed by the debtor."[20]

By this definition, any liability on a balance sheet could be classified as debt. This definition of debt would conflict with conventional financial definitions of debt, which typically exclude trade accounts payable.

The Tax Court also ignored the definition of debt included in other regulations, such as the U.S. Bankruptcy Code. Bankruptcy Code Section 101(12) defines debt as a "liability on a claim," and defines a claim as a legal "right to payment."[21]

Since BMC had a controlling interest in BSEH, did BMC technically then have the "power" to enforce the accounts receivable claim, and did it have a legal "right to payment" as defined by the terms of the accounts receivable closing agreement?

BMC argued in its appeal to the Fifth Circuit that "this court and numerous others have recognized that 'indebtedness' for federal income tax purposes requires 'existing unconditional and legally enforceable obligation to pay'" (*Tomlinson v. 1661 Corp.*, 377 F.2d 291, 295, Fifth Circuit 1967).[22]

The Tax Court did not introduce the concept of Bankruptcy Code Section 523, which lists certain liabilities that are nondischargeable in Chapter 11. Nondischargeable means that a borrower cannot seek relief from the obligation.

Section 523 states that liabilities will not be considered debt for the purposes of bankruptcy law "to the extent such debt is for a fine, penalty,

or forfeiture payable to and for the benefit of a governmental unit, and is not compensation for actual pecuniary loss, other than a tax penalty . . . imposed with respect to a transaction or event that occurred before three years before the date of the filing of the petition."

Section 523 was designed to stymie taxpayers from avoiding liabilities related to fines, penalties, and other legal obligations such as alimony payments. Section 523 seems to solidify such obligations as unavoidable, and since they are legally enforceable, fit within the Bankruptcy Code definition of debt.

If one were to define debt as an enforceable, legal obligation, would it be too much of a leap to deem the secondary adjustments accounts receivable as arising indirectly out of the BMC obligation to the Service? The BSEH liability to BMC may not have been owed to the Service directly, but it was owed to the Service indirectly.

This is because the transfer pricing adjustments, which gave rise to the creation of accounts receivable, did result from a tax penalty imposed on BMC. It remains to be seen if the BMC secondary adjustments accounts receivable will be deemed a liability by the Fifth Circuit for purposes of Section 965.

Legal Fictions under Revenue Procedure 99-32

The BMC secondary adjustments accounts receivable created pursuant to Revenue Procedure 99-32 were a legal fiction. This is because BMC did not actually loan money to BSEH, at least, not directly. If a company extends a loan to a CFC, but wishes to avoid having it classified as a loan, could it achieve this by overpaying for a service rendered by the CFC "accidentally" and later demand reimbursement?

What if an individual overpays their cellular phone bill, and later recognizes the error and requests a credit or refund? The amount is essentially an account receivable on the side of the individual, and an account payable on the side of the service provider. Would that overpayment constitute a loan to the service provider?

Debt is typically a contract entered into between two parties willingly and knowingly. BMC established the accounts receivable only because there was no recourse other than to pay a second, punitive tax. If you are forced to jump into a frigid swimming pool because a dog attacked you, did you jump into that pool willingly, or were you forced to jump into the pool by the dog?

Retroactive Establishment of Liabilities

What is the relevant date for establishing the secondary adjustment accounts receivable liability? BMC, in its reply brief on appeal to the Fifth Circuit, asserts that the accounts receivable was established over 20 months after the end of the tax year in which BMC received the special dividend and, therefore, it should not apply to the testing period.[23]

The Service, in its brief to the Fifth Circuit, contends that the accounts receivable was established between March 31, 2005, and March 31, 2006, which was during the testing period.[24]

Should the accounts receivable be dated retroactively to the testing period? Revenue Procedure 99-32 stipulates that the accounts receivable will "be deemed to have been created as of the last day of the taxpayer's taxable year for which the primary adjustment is made."[25]

Since there were adjustments for multiple years (i.e., 2003 through 2006), the Service contended that there were accounts receivable for multiple years, including when the special dividend was received in 2006.

Furthermore, is it relevant that the intent of Section 965(b)(3) was to prevent debt financed dividends? BMC argued that it did not directly finance the special dividend with debt, because the special dividend was paid before the establishment of the secondary adjustment accounts receivable.

But did BMC finance the dividend with debt after the fact? This is one question still pending before the Fifth Circuit.

Burden of Defining Terms Contained in a Closing Agreement

Who bears the burden of defining accounts receivable as debt in a closing agreement; the taxpayer or the Service? The Service contended that the responsibility was on BMC.

The Service cited *Bush v. United States*,[26] and noted that, if it was intended that a law not apply to the terms of the agreement, it should have been be so stated.

BMC argued, on appeal to the Fifth Circuit, that the closing agreement was based on language mandated by the Service,[27] implying that the responsibility was on the Service.

Because of this, BMC argued that it cannot be considered to be the drafter of the agreement, and was, therefore, not responsible for the omission of how debt was defined.

Accounts Receivable and Trade Receivables

Should the secondary adjustments accounts receivable be considered a trade receivable resulting from the ordinary course of business?

The Service, in its Notice 2005-38, set forth that "debt does not include the following ordinary course obligations of CFCs: a) obligations in the ordinary course of the CFC's business from sales, leases, licenses, or the rendition of services provided to or for a CFC by a related person, provided such obligations are actually paid within 183 days. See Section 7.02 of Notice 2005-38 and Section 10.08 of Notice 2005-64. . . ."[28]

This issue is debatable. On the one hand, the BMC royalty payments that eventually gave rise to the creation of the secondary adjustments accounts receivable, were paid in the ordinary course of business.

On the other hand, the secondary adjustments accounts receivable were for the amount of the excess of royalty payments above an arm's-length amount, which one may argue did not arise through the ordinary course of business.

Summary and Conclusion

This discussion presented a review of the tax matter related to the *BMC* decision.

In *BMC*, the Tax Court concluded that some of the money repatriated by BMC under the Section 965 special dividend in 2006 was ineligible for a lower tax rate.

This is because the Tax Court considered certain accounts receivables, established as a result of a subsequent and unrelated 2007 transfer pricing settlement, to be intercompany debt. The Tax Court, therefore, reduced the amount of dividends eligible for Section 965 repatriation.

This dispute may have been avoided if the closing agreement between BMC and the Service had been crafted with a clear definition of debt, a clear definition of whether the accounts receivable would be applied retroactive to the testing period, and/or a clear definition of whether the accounts receivable arose through the ordinary course of trade, which would have exempted it from classification as an increase in related-party debt for purposes of Section 965.

Notes:

1. 141 T.C. No. 5 (September 18, 2013).
2. Ibid.
3. Ibid.
4. Ibid.
5. Rev. Proc. 99-32, IRB 1999-34, C.B. 296, August 2, 1999.
6. Regulation 1.482-1(g)(3)(i).
7. 141 T.C. No. 5 (2013).
8. 375 F.2d 602 (D.C. Cir. 1967).
9. 141 T.C. No. 5 (2013).
10. United States v. Am. Trucking Ass'ns, Inc., 310 U.S. 534, 542-543 (1940).
11. Burlington No. R.R. Co. v. Okla. Tax Comm'n, 481 U.S. 454, 461 (1987); Miss. Poultry Ass'n, Inc. v. Madigan, 992 F.2d 1359, 1364 n.28 (5th Cir. 1993).
12. Gulf Opportunity Zone Act of 2005, Pub. L. No. 109-135, Sec. 403(q)(3), 119 Stat. at 2627.
13. Dixon v. Commissioner, 132 T.C. 55, 76 (2009).
14. *Black's Law Dictionary,* 8th Ed. (St. Paul, MN: West, 2004), 783.
15. Ibid., 18.
16. IRB Notice 2005-38, sec. 7.02(b).
17. Schering Corp. v. Commissioner, 69 T.C. 579 (1978).
18. 141 T.C. No. 5 (2013).
19. *Black's Law Dictionary*, 783.
20. No. 13-60684, BMC Software, Incorporated (appellant) v. Commissioner of Internal Revenue (appellee), BMC's reply brief, April 28, 2014, at 3.
21. U.S.C. Section 101(11) (1982).
22. No. 13-60684, BMC Software, Incorporated (appellant) v. Commissioner of Internal Revenue (appellee), BMC's reply brief, April 28, 2014, at 3.
23. Id. at 1.
24. Id., brief for the appellee, March 26, 2014, at 41.
25. Revenue Procedure 99-32, 26 CFR 601.105: "Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability."
26. 375 F.2d 602 (D.C. Cir. 1967).
27. No. 13-60684, BMC Software, Incorporated (appellant) v. Commissioner of Internal Revenue (appellee), BMC's reply brief, April 28, 2014, at 7.
28. IRC 965 Dividend Repatriation Audit Guidelines, LMSB-0808-043, August 27, 2008, http://www.irs.gov/Businesses/IRC-965-Dividend-Repatriation-Audit-Guidelines.

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Intangible Property in Transfer Pricing Analyses

Aaron M. Rotkowski

When a multinational corporation develops and owns intangible property that is used by its foreign subsidiaries, an arm's-length intercompany transfer price should be established as a charge for the use of the intangible property. The identification of intangible property transferred between related entities is often challenging because of (1) the interconnected relationship between multinational subsidiaries and (2) the broadly defined definition and interpretation of intangible property by taxing authorities. This discussion provides (1) a time line of events that have contributed to the current status of intangible property transfer pricing policy in the United States and abroad and (2) guidance for the identification of intangible property in intercompany transfer pricing analyses.

Introduction

Multinational corporations (MNCs) are facing increased scrutiny over their intercompany transfer pricing policies.

Let's consider, for example, some of the recent comments made by the Organisation for Economic Co-operation and Development (OECD):[1] "[T]he number of countries requiring preparation of transfer pricing documentation increases every year. The proliferation of transfer pricing documentation requirements, combined with a dramatic increase in the volume and complexity of international intra-group trade and the heightened scrutiny of transfer pricing issues by tax authorities, makes transfer pricing documentation one of the top tax compliance priorities on the agendas of both tax authorities and businesses."[2]

To that end, the OECD has developed a plan to prevent corporations from paying little or no income taxes.

The view of the United States towards transfer pricing resembles that of the OECD. In the last five years, the Internal Revenue Service (the "Service") has taken the following steps:

1. Created a dedicated transfer pricing group, Transfer Pricing Operations (TPO)
2. Hired its first transfer pricing director, Sam Maruca
3. Significantly increased the number of economists working on transfer pricing analyses.

One particular area of emphasis for both the OECD and the Service is the "abuse of transfer pricing rules in the key area of intangibles."[3]

According to paragraph 39 of the *Revised Discussion Draft on Transfer Pricing Aspects of Intangibles* published by the OECD, "Difficulties can arise in a transfer pricing analysis as a result of definitions of the term intangible that are either too narrow or too broad."

This discussion focuses on the various aspects of intangible property (also called intangible asset) identification that analysts should consider in tax-related intercompany transfer pricing analyses.

The next section of this discussion presents a time line of events that have shaped, and are continuing to shape, transfer pricing policy in the United States and abroad. The time line highlights events that affect intangible property.

Finally, this discussion summarizes some of the most significant tax-related transfer pricing regulations that are effective in the United States and throughout the rest of the world.

Transfer Pricing Time Line

The time line presented below lists key events in the tax-related transfer pricing field, with an emphasis on those events that affect intangible property.

April 1968 to July 2009

The Internal Revenue Code of 1968 was enacted. This edition of the Code included Section 482, which authorized the Service to allocate income, deductions, and credits between or among related entities in order to avoid tax evasion.

According to the Service, the Section 482 regulations "provided guidance with respect to a wide range of controlled transactions, including transfers of tangible and intangible property and the provision of services."[4]

The 1968 regulations included only general guidance with respect to intangible property.

Section 482 was subsequently updated, with the following notable revisions:

- 1986 regulations—to require that "in the case of any transfer (or license) of intangible property . . . the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible."
- 1992 proposed regulations, 1993 temporary regulations, and 1994 final regulations[5]—to (1) introduce the comparable profits interval (an important concept in the comparable profits method); (2) permit the use of a range when estimating the appropriate transfer price; and (3) introduce the "best method" rule, which states that "the arm's length result of a controlled transaction must be determined under the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result."[6] The 1994 final regulations were generally consistent with the 1993 temporary regulations.
- 2003 proposed regulations, 2006 temporary and proposed regulations, and 2009 final regulations—which covered intercompany service transactions and contained certain provisions relating to intangible property transactions.

June 1979 to July 2010

In June 1979, the OECD issued transfer pricing guidance in the report *Transfer Pricing and Multinational Enterprises*. This transfer pricing report underwent several subsequent updates. In 2010, the OECD published a major revision titled *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (the "Guidelines").

The most recent revision included significant changes to the chapters dealing with the arm's-length principle, transfer pricing methods and comparability analysis, and it also included a new chapter: "Transfer Pricing Aspects of Business Restructurings."

The Guidelines have been incorporated into domestic law for a number of countries and have served as the transfer pricing norm for many others. The Guidelines also "provide the agreed framework for resolution of competent authority cases between OECD member states, including the United States."[7]

September 2006

The Service settled an intercompany transfer pricing tax dispute with Glaxo SmithKline Holdings (Americas) Inc. & Subsidiaries (GSK) for $3.4 billion. This remains one of the largest and most significant transfer pricing cases in the United States.

According to the Service, "at issue is the level of U.S. profits reported by GSK after making intercompany payments that took into account product intangibles developed by and trademarks owned by its U.K. parent, and other activities outside the U.S., and the value of GSK's marketing and other contributions in the U.S."[8]

2010

The Service created the large business and international (LBI) division to enhance its focus on international tax administration. At the time the LBI was formed, it had planned to add 875 employees to the existing staff of 600.

2011

The Service created the TPO group and hired its first transfer pricing director, Sam Maruca. Maruca has repeatedly said that he considers intangibles to be the top priority for the TPO group's activities.

June 2012

The OECD published a discussion draft (also referred to as an interim draft) titled, *Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions* (the "OECD 2012 Discussion Draft").

The document contained two principal elements:

1. A proposed revision of the provisions of Chapter VI, Special Considerations for Intangible Property, of the transfer pricing guidelines
2. Proposed revision of the Annex to Chapter VI containing examples that illustrate the application of the provisions of the revised text of Chapter VI

May 2013

The Base Erosion and Profit Sharing (BEPS) project was formed as a joint project between the OECD and G20 to look at whether or not the current transfer pricing rules allow for the allocation of taxable profits to locations different from those where the actual business activity takes place, and what could be done to change this if they do.

June 2013

House Ways and Means Committee Chairman, Representative Dave Camp (R-MI) introduced legislation that would reduce the tax rate to a flat 15.0 percent on foreign income attributable to intellectual property.

July 2013

The OECD published an action plan on BEPS (the "action plan"). The action plan, endorsed by the G20, "offers a global roadmap that will allow governments to collect the tax revenue they need to serve their citizens."[9]

Specifically, the action plan "identifies 15 specific actions that will give governments the domestic and internal instruments to prevent corporations from paying little or no taxes."`[10]

One of the intended goals of the action plan is to ensure "that taxable profits cannot be artificially shifted, through the transfer of intangibles."[11]

Certain actions developed in the action plan will be implemented by direct changes to the Guidelines, while other changes will be implemented by countries through their domestic law, bilateral treaties, or a multilateral instrument.[12]

According to the action plan, Action 8, Intangibles, is stated as follows:

> Develop rules to prevent BEPS by moving intangibles among group members. This will involve: (i) adopting a broad and clearly delineated definition of intangibles; (ii) ensuring that profits associated with the transfer and use of intangibles are appropriately allocated in accordance with (rather than divorced from) value creation; (iii) developing transfer pricing rules or special measures for transfers of hard-to-value intangibles; and (iv) updating the guidance on cost contribution arrangements.

July 2013

The OECD published *Revised Discussion Draft on Transfer Pricing Aspects of Intangibles* (the "Discussion Draft"). This document replaced the OECD 2012 Discussion Draft and incorporated the comments that were received with respect to the OECD 2012 Discussion Draft.

September 2013

Senator Carl Levin introduced a bill named "The Stop Tax Haven Abuse Act" to lower the incentives of moving intellectual property or operations offshore, which included a provision to tax excess profit related to transferred intellectual property.

November 2013

The U.S. announced Revenue Procedure 2013-78 ("Proposed Revision of Procedures for Requesting Competent Authority and Assistance Under Tax Treaties") and 2013-79 ("Proposed Revision of Procedures for Advance Pricing Agreements").

March 2014

The Obama administration proposed budget included a proposal to broaden the definition of intangible property in the Section 482 regulations to include:

> workforce in place, goodwill, and going concern value, and any other item owned or controlled by a taxpayer that is not a tangible or financial asset and that has substantial value independent of the services of any individual. The proposal also would clarify that where multiple intangible properties are transferred, or where intangible property is transferred with other property or services, the Commissioner may value the properties or services on an aggregate basis where that achieves a more reliable result.[13]

The proposed budget would also extend the Subpart F rules to include certain "excess income" that offshore controlled foreign corporations earn from intangible assets transferred out of the United States.

Similar versions of these proposals were included in the administration's budget proposals between the years 2010 and 2014.

September 2014

The OECD released the first recommendations to address the BEPS action plan published in July 2013 (the "BEPS deliverables). Action 8, Intangibles, was among the actions that were addressed in the 2014 deliverables.

The next section of this discussion summarizes some of the publications and regulations with regard to the identification of intangible property for tax-related transfer pricing purposes.

Section 482 Definition of Intangible Asset

Congress created Section 482 to address the concern that a domestic taxpayer could shelter income to avoid taxes by transferring assets to a foreign affiliate. Likewise, the Service is concerned 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 intercompany transfer prices charged in multinational asset transfers. An intercompany transfer price is the price that one entity charges a related party for the use of:

1. tangible property,
2. intangible property, or
3. services.

The goal of 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 an 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. . . ."[14]

Under the Section 482 regulations, the arm's-length consideration for the transfer of intangible property should be commensurate with the income attributable to that intangible property.

The Section 482 regulations define an intangible property as follows:

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

Analysts are likely to be familiar with the intangible property list provided in the Section 482 regulations. However, it is item number six—other similar items—that transfer pricing disputes often revolve around. In instances where intangible property is broadly defined, such as in item number six, analysts often consider economic definitions of intangible property in order to determine if an intangible property exists.

One source of such definition is the *Guide to Intangible Asset Valuation*[15] (*GIAV*). *GIAV* includes lists of (1) characteristics of intangible property and (2) economic phenomena that do not qualify as intangible property.

The following characteristics of intangible property are provided in GIAV:[16]

> An intangible asset has the following ownership characteristics:
>
> 1. It may be subject to a specific identification and a recognizable description.
> 2. It may be subject to legal existence and legal protection.
> 3. It may be subject to the rights of private ownership, and that private ownership should be transferable.
> 4. It may be documented by some tangible evidence or manifestation of the existence of the intangible asset (for example, a contract, a license, a registration document, a compact disc, a listing of customers, or a set of financial statements).
> 5. It may be created or come into existence at an identifiable time or as the result of an identifiable event.

6. It may be subject to being destroyed or to a termination of existence at an identifiable time or as the result of an identifiable event.

When defining intangible property from an economic perspective, it is also often useful to consider economic phenomena that do not qualify as intangible property.

According to *GIAV*, the following nonexhaustive economic phenomena do not qualify as intangible property, even though they may be considered intangible factors or influences:[17]

- High market share
- High profitability or high profit margin
- Heritage or longevity
- Competitive edge
- Uniqueness
- Positive image
- Technological superiority
- Consumer confidence or trustworthiness

The guidance provided in *GIAV* can help analysts identify intangible property and the "other similar items" that both qualify and do not qualify as an intangible property for purposes of Section 482 compliance.

OECD Guidelines and BEPS Definition of Intangible Property

The United States is a member country to the OECD, and is an active contributor in the development of the Guidelines. Therefore, many of the concepts that appear in the Section 482 regulations also appear in the Guidelines.

For example, the arm's-length price standard in the Section 482 regulations closely resembles the arm's-length charge standard in the Guidelines. Likewise, the best method rule in the Section 482 regulations is analogous to the most appropriate method principle in the Guidelines.

Similar to the Section 482 regulations, the Guidelines include a chapter devoted to intangible property. According to Chapter VI of the Guidelines, "the term 'intangible property' includes rights to use industrial assets such as patents, trademarks, trade names, designs or models. It also includes literary and artistic property rights, and intellectual property such as know-how and trade secrets."

The Guidelines distinguish between marketing intangible property and commercial intangible property. According to Chapter VI, B.1, of the Guidelines:

> Commercial intangibles include patents, know-how, designs, and models that are used for the production of a good or the provision of a service, as well as intangible rights that are themselves business assets transferred to customers or used in the operation of business (e.g. computer software). . . . Marketing intangibles 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.

As noted above, the OECD is in the process of revising the intangible property chapter in the Guidelines. The current iteration of this revision is documented in the Discussion Draft and the BEPS deliverables. The OECD is separately working to address other related issues of base erosion and profit shifting through the BEPS action plan.

Although it is separate from the Guidelines, the work being done on the action plan related to intangible property is closely related to the Guidelines, and action plan recommendations and revisions to the Guidelines will be addressed together.

The next section of this discussion focuses on the identification and the valuation of intangible property in the Discussion Draft and the BEPS deliverables.

OECD 2013 Discussion Draft

The Discussion Draft addresses the identification of intangible property, and it also addresses topics such as location savings and other local market features, assembled workforce, synergies, the ownership of intangible assets, and supplemental guidance for determining arm's-length conditions for the relevant intangible property transaction.

The Discussion Draft proposes a revised Chapter VI, Special Considerations for Intangibles for the Guidelines. One change that is apparent is the proposed broadening of the definition of intangible property in the Discussion Draft.

Subsequent to publishing the Discussion Draft, the OECD published the BEPS deliverables. This document included a revised Chapter VI for the Guidelines. This revised Chapter VI replaces the information in the Discussion Draft. The 2014 BEPS Deliverables is discussed next.

2014 BEPS Deliverables

As discussed above, the OECD issued a discussion draft that specifically addressed the intercompany transfer pricing aspects of intangible property. This work dovetails with the joint OECD/G20 BEPS project, as the work on intangible property is specifically listed as one of the BEPS actions in the action plan.

The BEPS deliverables address the same topics that are addressed in the Discussion Draft, including topics unrelated to the identification of intangible property. Those other issues are not addressed herein. The focus of this discussion is the identification of intangible property.

Much of the information in the BEPS deliverables is similar to the information in the Discussion Draft. As noted above, the BEPS deliverables supersedes the Discussion Draft.

In the context of the BEPS deliverables, identifying intangible property means to:

1. identify the intangible property involved in the transaction(s),
2. identify which entity or entities legally own the intangible(s), and
3. identify which entity or entities contribute to the value of the intangible property (paragraph 6.104).

This discussion focuses on the first item in that list: identifying the intangible property.

The BEPS deliverables continues the trend of broadening the definition of "intangible" with regard to transfer pricing analyses. For example, paragraph 6.2 of the BEPS deliverables notes that:

> the key consideration is *whether a transaction conveys economic value* [emphasis added] from one associated enterprise to another, whether that benefit derives from tangible property, intangibles, services or other items or activities. An item or activity can convey economic value notwithstanding the fact that it may not be specifically addressed in Chapter VI. To the extent that an item or activity conveys economic value, it should be taken into account in the determination of arm's length prices whether or not it constitutes an intangible within the meaning of paragraph 6.6.

Further, paragraph 6.6 notes that:

> In these Guidelines, therefore, the word "intangible" is intended to address something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances.

In this discussion, the terms "intangible" and "intangible property" are used interchangeably.

As shown in the above two citations, an intangible property is not defined by reference to a list of allowable intangible property. Rather, the definition in the BEPS deliverables is sufficiently broad to give a taxing authority significant discretion when analyzing a transaction for intangible property.

The most blatant example of this is the paragraph 6.6 definition above that begins the definition of an intangible property as "something" that is neither physical nor financial. The definition goes on to limit the entire universe of "things" that are neither tangible nor financial to only those "things" that are capable of being owned or controlled, and whose transfer would be compensable.

However, even with those limiting conditions on the entire universe of "things" that are neither physical nor financial, the definition of intangible property remains broad relative to common economic definitions of intangible property.

The BEPS deliverables also differentiates its definition of intangible property with the financial accounting definition of intangible property. The BEPS deliverables definition is the broader of the two definitions of intangible property.

According to BEPS deliverables paragraph 6.7, "Intangibles that are important to consider for transfer pricing purposes are not always recognised as intangible assets for accounting purposes." That is, even if an asset doesn't qualify as an intangible property for accounting purposes, it may still be appropriate to estimate a transfer price for that asset in a controlled transaction.

The BEPS deliverables further broadens the definition of an intangible property by *not* requiring an item to (1) enjoy legal protection or (2) be separately transferable in order to be considered an intangible property (BEPS deliverables paragraph 6.8). As previously discussed, these are common characteristics of intangible property from an economic perspective.

By comparing the economic definition of intangible property provided above to the BEPS deliverables definition, one can see how economic phenomena that do not qualify as an intangible property could be included as an intangible property for tax-related intercompany transfer pricing purposes.

The functional analysis that is typically included in a tax-related transfer price analysis should support the identification of an intangible property.

Functional analysis is a procedure to identify and organize facts related to the functions performed, risks assumed, and intangible property owned by the various companies of an affiliated group.

The purpose of the functional analysis is to accurately characterize the value-added activities undertaken by a particular entity in order to identify appropriate comparable transactions from which to establish arm's-length consideration for the activities.[18]

The functional analysis is especially important if the identified intangible in a tax-related transfer pricing analysis is broader than what would normally be considered an intangible property from an economic perspective.

Although the revised chapter VI of the Guidelines that is included in the BEPS deliverables is more voluminous than the existing Guidelines, much of the new information is open to interpretation.

To clarify the information in the identifying intangibles section of the BEPS deliverables, the document includes a section that provides illustrations of items often considered in transfer pricing analyses involving intangible property.

One intangible property in particular that is included in that section and is worth discussing herein is "goodwill and ongoing concern value." The BEPS deliverables do not precisely define goodwill and ongoing concern value; and, they note that financial accounting or business valuation definitions of goodwill do not correspond to the goodwill definition used in transfer pricing analyses.

When it comes to defining goodwill and ongoing concern value, Paragraph 6.28 of the BEPS deliverables notes that, "It is not necessary for purposes of this Chapter to establish a precise definition of goodwill or ongoing concern value for transfer pricing purposes or to define when goodwill or ongoing concern value may or may not constitute an intangible."

Absent a definition, the qualities that the BEPS deliverables attribute to goodwill and ongoing concern value include qualities such as a reputation for producing high quality products that enables a company to charge higher prices.

The document also provides examples that further illuminate the OECD intentions regarding the treatment of goodwill. Paragraph 6.92 of the BEPS deliverables notes, "For example, the transfer of rights to use a trademark under a licence agreement will usually also imply the licensing of the reputational value, sometimes referred to as goodwill, associated with that trademark, where it is the licensor who has built up such goodwill. Any licence fee required should consider both the trademark and the associated reputational value."

This concept is also illustrated in Example 21 of the BEPS deliverables, which is presented in paragraphs 71 through 73. In that example, the arm's-length charge for various identified intangible property such as patents, customer lists, and distribution rights is said to reflect "the value of the business which would include amounts that may be treated as the value of goodwill for accounting purposes [in a purchase price allocation]."

The most frequent way that the BEPS deliverables include goodwill in a transfer price is by including the value of goodwill in the transfer price of another intangible property, such as a trademark. Example 23 in the BEPS deliverables deals with that situation. The conclusion of Example 23 (paragraphs 79 through 83) is that the arm's-length charge for licenses should take into account the "value ascribed to goodwill for accounting purposes."

Note that this example does not say that all of the entity's goodwill should be included in the licenses transfer price. Presumably, the amount of goodwill that is included in the arm's-length charge for the licenses will be based on the functional analysis, among other case-specific factors.

Regardless of how goodwill is defined for a particular purpose, there are certain common economic attributes of goodwill that are consistent among the various goodwill definitions. These economic attributes can be instructive when the analyst or corporate tax professional is analyzing goodwill for tax-related transfer pricing purposes (such as the example given directly above), and they can be especially helpful given the lack of specificity to which goodwill is defined in either the Guidelines or the BEPS deliverables.

GIAV describes goodwill as having three components.

The first component is the existence of operating business assets that are in place and ready to use. This component is often referred to as going concern value. The second component is the ability of the business to earn a return that is greater than the amount needed to provide a fair rate of return on all of the business's tangible and identifiable intangible property. The third and final component of goodwill is expectation of future events that are not directly related to the business's future operations.

Transfer price analysts and corporate tax professionals should consider that some of the goodwill value may be related to assets that don't exist as of a particular analysis date (i.e., the third component

of goodwill). This can be illustrated by the following example.

Let's assume that a very large and successful fast food company operated exclusively in the U.S. Let's further assume that this fast food company was expanding into a new country, and the U.S. parent company will create a foreign subsidiary to own and operate the foreign fast food business.

Finally, let's assume that the U.S. parent company projects that it will expand rapidly in the new market and have $100 million of fast foods sales in the foreign country in five years.

Upon entering this new market, the intangible property that may be transferred from the United States to the foreign country may include such intangible property as training manuals, recipes, trademarks, and the like.

However, if the brand name is not well known in the foreign country, the value of the intangible property, such as trademarks and trade names, may only have a nominal value.

In this example, the transfer of goodwill may be an important consideration in the overall transfer price analysis. If the value of goodwill is estimated as the business value of the foreign entity minus all of its identified tangible and identified intangible property, then the amount of goodwill in the foreign business entity could be substantial.

This is because the value of goodwill would include the expectation of future events (e.g., future customers, future products, and future store growth) and, accordingly, property that does not exist as of the analysis date.

Not all of this goodwill may be relevant for a tax-related transfer pricing analysis. That is because a component of this goodwill may include value attributable to future property (i.e., the third goodwill component described above).

The transfer price analyst should understand with relative specificity what subject company attributes are included in the goodwill that is included in the transfer price analysis. The analyst should also be careful that only those assets that are subject to a transfer price charge are included in the tax-related transfer price analysis.

Although the BEPS deliverables provide for broad discretion regarding the identification of intangible property, they nonetheless require that intangible assets be specifically identified. When goodwill is included in a transfer price, the specific attributes of goodwill that give rise to a transfer price should be identified and analyzed.

Based on the BEPS deliverables, it will not be acceptable to "suggest that vaguely specified or undifferentiated intangibles have an effect on arm's length prices or other conditions."[19]

Conclusion

This discussion provided a time line of events that have contributed to the current status of intangible property transfer pricing policy in the United States and abroad.

A signification portion of this discussion is related to the BEPS deliverables. Although the Section 482 regulations provide the relevant guidance for the U.S. tax-related transfer price analyses, the work by the OECD is nonetheless important for U.S. analysts and corporate tax professionals.

This is because:

1. the United States is a member of OECD, and it can influence the OECD intercompany transfer pricing guidelines and
2. the BEPS deliverables is representative of where intercompany transfer pricing in the United States may be headed.

Consider, for example, that in 2014 there were proposals from both the U.S. Senate and the White House that resemble the work being done by the OECD.

This discussion also presented an update on the guidance surrounding intangible property identification for tax transfer pricing purposes. What is clear from the above discussion is that the definition of intangible property for transfer pricing purposes:

1. is being expanded and
2. leaves room for interpretation.

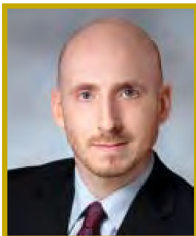
By broadly and vaguely defining "intangible asset," the OECD has placed a greater emphasis on the functional analysis in a transfer pricing analysis. Paragraph 6.86 of the BEPS deliverables notes that "labels applied to transactions do not control the transfer pricing analysis. . . . Thus, the functional analysis should identify the nature of the transferred rights in intangibles with specificity."

For these reasons, it is important for analysts to have a clear understanding of the appropriate regulations and to work closely with their clients to develop tax-related transfer pricing analyses that specifically identify the intangible property transferred in a controlled transaction.

"By broadly and vaguely defining 'intangible asset,' the OECD has placed a greater emphasis on the functional analysis in a transfer pricing analysis."

Notes:

1. The OECD mission is to promote policies that will improve the economic and social well-being of people around the world. Thirty-four countries are OECD members, including the United States and Canada.
2. OECD, *Public Consultation, White Paper on Transfer Pricing Documentation*, July 30, 3013.
3. OECD (2014), *Explanatory Statement*, OECD/G20 Base Erosion and Profit Sharing Project, OECD. www.oecd.org/tax/beps-2014-deliverables-explanatory-statement.pdf
4. http://www.irs.gov/pub/irs-apa/proposed_services_regs.pdf.
5. Note that although these two revisions were separate, they are grouped here because the 1993 temporary regulations were largely issued because of the heavy criticism that was given to the 1992 proposed regulations.
6. Treas. Reg. § 1.482 -1(c)
7. Baker & McKenzie, North American Tax Practice Group, "Transfer Pricing: Managing Intercompany Pricing in the 21st Century," (Chicago: Baker & McKenzie Global Services, LLC, 2012), 5.
8. IRS Newswire, "IRS Accepts Settlement Offer in Largest Transfer Pricing Dispute" (September 11, 2006) http://www.irs.gov/uac/IRS-Accepts-Settlement-Offer-in-Largest-Transfer-Pricing-Dispute.
9. www.oecd.org/tax/closing-tax-gaps-oecd-launches-action-plan-on-base-erosion-and-profit-shifting.htm
10. Ibid.
11. Ibid.
12. www.oecd.org/ctp/beps-frequentlyaskedquestions.htm
13. Department of Treasury, "General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals" (March 2014).
14. Treas. Reg. § 1.482-1(b)(1).
15. Robert F. Reilly and Robert P. Schweihs, *Guide to Intangible Asset Valuation* (New York: American Institute of Certified Public Accountants, 2014).
16. Ibid.: 3.
17. Ibid.: 6.
18. See for example, the Guidelines glossary and the Guidelines paragraph 1.42.
19. BEPS deliverables, paragraph 6.12.



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Standard of Value

Continued from page 33

original transaction is compared and adjusted based on company-specific factors. Accordingly, the arm's-length price standard offers a subjective and entity-specific analysis.

The fair value standard, unlike the arm's-length price standard, develops a one-sided value conclusion based on the perspective of the seller. Instead of including information about the buyer in the analysis, or developing a range of values, the fair value standard requires the analyst to assume the highest and best use for the subject property, regardless of the intended or actual use of the subject asset or liability. In general, the fair value standard offers a more objective analysis.

Analyses performed for different purposes, using different standards of value, can result in different value conclusions. The arm's-length price standard and the fair value standard have inherent conceptual differences which can result in the difference between a subjective value conclusion and an objective value conclusion.

Notes:

1. ASC 820-10-35-9A.
2. Internal Revenue Code Sections 84A(2), 475(a)(1), 307(b)(1)(B), et al.
3. 26 U.S. Code § 7805 – Rules and regulations.
4. Treas. Reg. §1.170A-1(c)(2), 20.2031-1(b), and 25.2512-(1).
5. Treas. Reg. §1.482-1(b)(1).
6. Para. 1.6 of the OECD guidelines.
7. Jens Wittendorff, "The Arm's-Length Principle and Fair Value: Identical Twins or Just Close Relatives?" *Tax Notes International* (April 18, 2011): 223–249.
8. Treas. Reg. §1.482-1(f)(2)(ii)(A).
9. ASC 820-10-35-2B.
10. ASC 820-10-35-9A.
11. Treas. Reg. §1.482-1(b)(1).
12. Ibid.
13. ASC 820-10-35-2.
14. ASC 820-10-34-5.
15. Treas. Reg. §1.482-1(d)(4)(ii).
16. Treas. Reg. §1.482-1(d)(4)(ii)(C).
17. ASC 820-10-35-9.
18. Treas. Reg. §1.482-1(d)(1) and ASC 820-10-35-9.
19. ASC 820-10-35-10C.
20. Treas. Reg. §1.482-1(e)(1).

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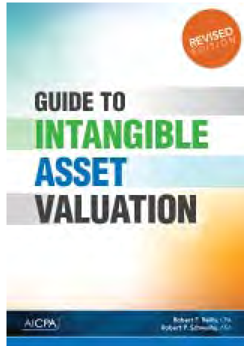
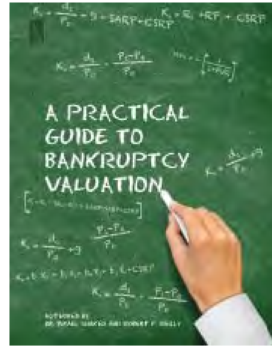
Valuation Textbooks Authored by Robert Reilly and Robert Schweihs





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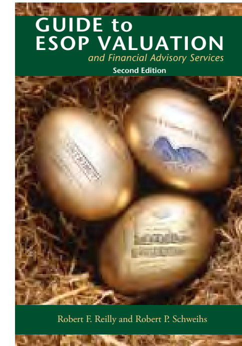

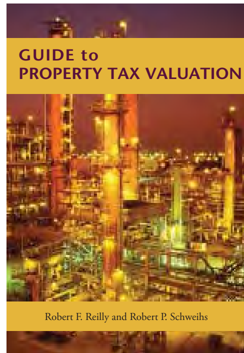

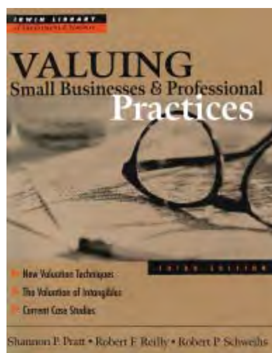

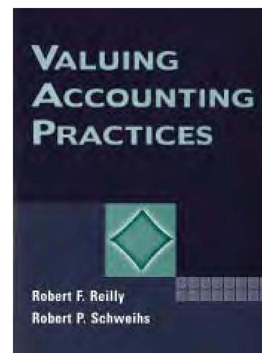

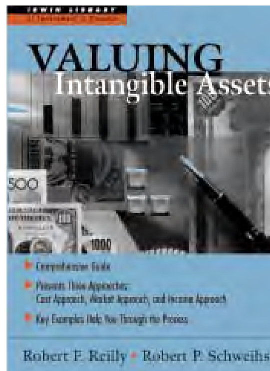

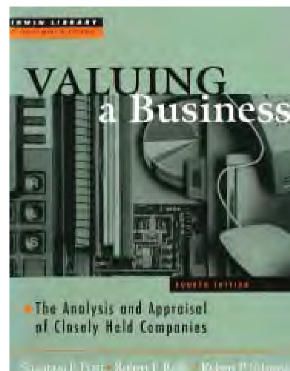

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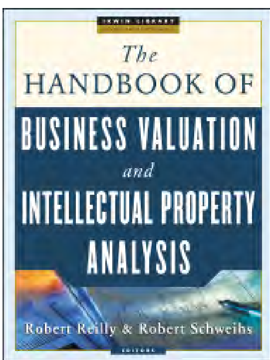

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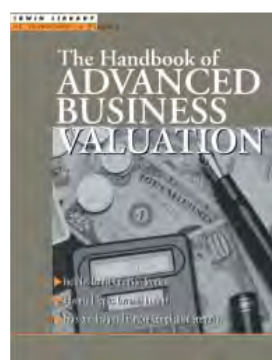

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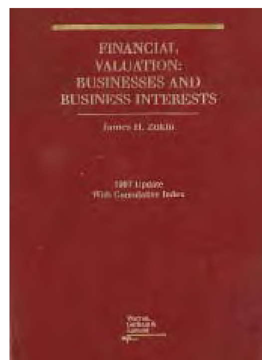

* Authored by Robert Reilly and Israel Shaked, Ph.D.
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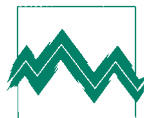

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Best Practices

The Valuation of Trademark-Related Intangible Property

John E. Elmore, JD, CPA

Valuation analysts are often called on to perform valuation, damages, and transfer price analyses of trademark-related intangible property for various purposes. This discussion describes the valuation of trademarks within the context of both financial accounting and income tax accounting (in particular, tax-related intercompany transfer pricing). This discussion summarizes the generally accepted trademark analysis approaches and methods, particularly within the context of financial accounting and tax-related transfer price analysis. And, this discussion presents three examples, using different analytical methods, to illustrate the analysis of trademarks.

Introduction

Trademarks present a difficult but interesting challenge from a valuation, damages, and transfer price perspective. They represent an important tool of commerce and can become very valuable. *Forbes* magazine recently listed the "Google" trademark as the world's most valuable at $44 billion, exceeding the gross domestic product of many small countries.

This discussion describes the factors that are relevant to the valuation, damages, and transfer price of trademark-related intangible property in a variety of contexts, including financial accounting and tax-related transfer pricing.

This discussion explains the generally accepted trademark valuation approaches and methods as it applies to these contexts. And this discussion presents three examples to illustrate the trademark analysis approaches and methods described.

Description of Trademark-Related Intangible Property

What is a trademark and what economic advantages does it provide? Under the Trademark Act of 1947 (the Lanham Act), the statutory federal laws governing trademark rights, a trademark is defined as "any word, name, symbol, or design, or any combination thereof, used in commerce to identify and distinguish the goods of one manufacturer or seller from those of another and to indicate the source of the goods."[1]

At its essence, a trademark is an economic tool to help consumers to assess the quality of goods and services in making a purchase decision based on the reputation of the manufacturer or seller.

Businesses that provide higher quality products enjoy more goodwill in the mind of typical consumers than those that do not. Advertising plays an important role in shaping and reinforcing this goodwill.

Marketing and other corporate executives tend to conflate a trademark with the marketing concept of a brand. Indeed, the two concepts may be hard for laypersons to distinguish, particularly where a trademark represents an entire business enterprise like it does for Google. For this reason, many laypersons use the terms interchangeably.

However, this conflation of the terms trademark and brand is not technically correct. A trademark, at its essence, serves as but one identifier of a brand—it does not reflect the entirety of the brand itself. Think of it this way: a business with a good reputation can enjoy an advantage over a competitor even if it employs no trademark.

Customers, for example, may distinguish the business by its location or owner, or the business may simply employ names or symbols for which it possesses no trademark rights. It follows that the value of a trademark ordinarily is something less than the value of a brand.

Further confusing the distinction between a brand and a trademark for nonpractitioners is the use of trade names. A trade name is a name used to identify a business. But unless it is also registered as a trademark, or recognized under common law as a trademark, it generally carries no legal rights of protection and has no material value as an asset for valuation purposes.

This is also true of domain names. A domain name is part of a web address that links to the internet protocol (IP) address of a particular website. Registration of a domain name with a domain name registrar provides no trademark protection; instead, a separate trademark registration is necessary.

As is true for other intellectual property, a trademark conveys a bundle of legal rights and protections to its owner. These rights include the right to exclude others from employing the trademark if such use would cause confusion in the marketplace.

When the entire bundle of rights is transferred to another party, an assignment is given. Anything less than a transfer of the entire bundle of rights is a license. The licensee pays for those rights by means of a royalty.

Trademark Registration

Trademarks are created through use and do not require registration. Registration is generally recommended, however, because it offers additional benefits over common law trademark protection.

A trademark can be recognized under common law in the geographic area in which it is used, the channel of trade in which the goods or services are sold, and for the goods or services with which the trademark is used.

A trademark is registered with the United States Patent and Trademark Office (USPTO) via an application process. Registration provides constructive notice to the public of the registrant's claim of exclusive rights to the trademark and serves as *prima facia* evidence of the ownership and validity of the trademark.[2]

If a registration has been on the register for more than five years, has been in continuous use during that time, and has not been the subject of an adverse or pending proceeding, the registrant can file to have the trademark declared incontestable.

Once a trademark is declared incontestable, the registration is deemed to be conclusive evidence of the exclusive right to use the registered mark in commerce.

Each registration of a trademark with the USPTO remains in force for a 10-year term. An owner can renew the registration for successive 10-year terms upon filing an application.

Trademarks, strictly speaking, are marks used to identify goods. Marks used to identify services are registered as service marks. For the purpose of this discussion, however, the term "trademark" will be used in the collective sense to refer to both trademarks and service marks.

Valuation Purposes

There are a myriad of reasons why analysts would be asked to value a trademark. Those reasons often fall into one of three buckets:

1. Valuation for transactional purposes other than tax compliance
2. Valuation for financial accounting purposes
3. Valuation for income tax and other tax compliance purposes

The first bucket of reasons pertains broadly to transactions between parties that involve a trademark where the value of the trademark is necessary to define the terms of the transaction or otherwise complete the transaction. For example, a buyer may require independent assessment of a trademark's value.

A lender may require the valuation of a trademark before the trademark can be pledged as part of the collateral for a loan.

The second bucket of reasons pertains to financial accounting requirements under the securities laws of governing jurisdictions. In the United States,

federal securities law is enforced by the Securities and Exchange Commission (SEC). The SEC may, under certain circumstances, require the recognition of trademarks and other intangible property on a reporting company's balance sheet. For example, this may occur when a trademark is acquired in a business combination.

The SEC designated the Financial Accounting Standards Board (FASB) as the authoritative organization in the private sector for standardizing generally accepted accounting principles (GAAP) that govern the preparation of financial statements.

These standards are known as the Accounting Standards Codification (ASC). ASC topic 805 governs business combinations and requires the recognition of trademarks acquired as a result of a business merger or acquisition.

Paragraph 2-5-5 of ASC topic 805 states:

> All identifiable intangible assets that are acquired in a business combination should be recognized at fair value on the acquisition date. Identifiable intangible assets are recognized separately if they arise from contractual or other legal rights or if they are separable (i.e., capable of being sold, transferred, licensed, rented, or exchanged separately from the entity).

A trademark is recognized on a reporting company's balance sheet as an intangible asset separate from goodwill because it satisfies either of the following two tests under paragraph 2-5-5:

1. It arises from legal rights (remember, a trademark is essentially a bundle of rights)
2. It is capable of being sold, transferred, and licensed separately from other assets of the acquiring company

The recognition of an acquired trademark is performed as part of a purchase price allocation (PPA), whereby a portion of the price paid by the acquirer for all of the acquired assets is assigned to the trademark using an acceptable valuation methodology. Later, this discussion explores in more detail the valuation of a trademark within a financial accounting context.

The third bucket of reasons pertains to the analysis of a trademark for tax compliance purposes. Many transactions involving the sale or transfer of trademarks qualify as taxable events. Income tax rules generally stipulate how the tax basis of transferred assets is determined and what expenses associated with the assets are permissible for computing taxable income.

An important and challenging area of federal income tax compliance is known as intercompany transfer pricing. At a general level, intercompany transfer pricing involves the setting of prices for exchanges of goods, services, or use of intellectual property, such as trademarks, between two or more controlled entities located in different tax jurisdictions.

Often, agreements are structured between subsidiaries of multinational corporations located in different countries with the aim of minimizing the total amount of corporate income tax paid. Tax jurisdictions have developed rules to ensure that these agreements have economic substance and reflect market realities so as to not become a tool of tax avoidance.

Chief among these rules is the requirement known as the "arm's-length standard," which is codified in the Section 482 regulations.[3]

The Section 482 regulations state in part:

> In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer. A controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances.[4]

Valuation standards applied in the financial accounting context and in the tax-related transfer pricing context share a general consistency; namely, a market perspective is imposed upon the transactions. In the financial accounting context, accounting for the acquisition of a trademark is performed under the fair value standard.

The fair value standard is defined in ASC topic 820. ASC topic 820 requires that the valuation of the trademark reflect the consideration of what a market participant would pay for the trademark in a bargaining situation in view of the highest and best use of the trademark regardless of how the acquirer intends to use it.

Similarly, in the tax-related transfer pricing context, the benchmark for the transfer price of a trademark is determined in consideration of what "uncontrolled taxpayers"—essentially, market participants—would agree to pay in a bargaining situation.

Generally Accepted Trademark Valuation Approaches and Methods

Three generally accepted valuation approaches are employed by valuation analysts to estimate the value intangible property, including trademarks.

These generally accepted intangible property valuation approaches are as follows:

1. The cost approach
2. The market approach
3. The income approach

The cost approach is less commonly used to estimate the value of trademarks than the other approaches. This is because the concept of cost is ordinarily not the same as the concept of value. Analysts may use more than one valuation approach, or more than one valuation method of a particular valuation approach, and then synthesize the results of the various analyses.

The transfer pricing rules under the Section 482 regulations impose a further framework incorporating elements of these valuation approaches in a manner designed to satisfy the arm's-length price standard for income tax compliance purposes.

Cost Approach

Because a trademark grants exclusive rights to the owner, it provides economic advantages that ordinarily are not fully reflected in the cost to create and develop the trademark. The cost approach, therefore, is not always applicable to a trademark valuation analysis.

Nonetheless, the cost approach does have application to trademarks in certain circumstances, such as where the trademark is not being used by the owner. The cost approach typically reflects a minimum value of the trademark, as the owner ordinarily will not sell the trademark for less than the owner's investment in it.

The replacement cost new less depreciation method is often used for valuing trademarks under the cost approach. Sometimes the term "re-creation cost" is used instead to reflect the notion that a trademark is a creative or artistic form of intellectual property.

The replacement cost new less depreciation method requires identification of all costs that may be incurred in re-creating the trademark. These costs would include legal fees, registration fees, and advertising costs for promoting the trademark.

The analyst should also consider as cost components both:

1. developer's profit and
2. entrepreneurial incentive.

These two components are often overlooked by inexperienced analysts. The developer's profit reflects the reasonable profit expected on the development costs incurred in the creation of the trademark. And the entrepreneurial profit reflects the economic benefit required to motivate the trademark creator into the development process, which is often viewed as an opportunity cost.

Finally, the analyst should adjust the cost estimate for all forms of obsolescence. The replacement cost new less depreciation method is based on present costs and circumstances, so its resulting value may be greater than that of the trademark actually being assessed.

Market Approach

Because trademarks are associated with particular products and businesses, sales of trademarks are less common than licenses for their use. As such, there exists a fair amount of publicly available information on trademark licensing, often collected from financial reports filed with the SEC. This information allows the analyst to develop units of comparison for trademarks, most notably a royalty rate.

The relief from royalty method makes use of the royalty rates involved in comparable uncontrolled transactions (CUT)—essentially, comparable arm's-length trademark license transactions between willing buyers and willing sellers—to derive the value of the subject trademark.

The theory behind the relief from royalty method is one of cost avoidance—that is, the value of the trademark is reflected in the trademark license royalty payments the trademark owner avoided having to pay by owning the trademark.

In this method, the analyst assumes the actual owner does not own the trademark and, therefore, must pay a hypothetical third party for a license to use it. The hypothetical trademark royalty payment is calculated as a market-derived running royalty rate multiplied by the actual owner's projected revenue over the remaining useful life of the trademark.

Because the relief from royalty method depends on applying the royalty rate to the projected revenue, it overlaps with the income approach, and some analysts will characterize this method as an income approach method.

“. . . comparable trademark license transactions are those involving a similar product or business to that of the subject trademark. . . .”

The selected trademark royalty rate is determined from an analysis of the CUT trademark license royalty rates. No “true comparable” exists because trademarks are, by their nature, unique.

So, in practice, the analyst typically identifies CUT licenses based on a degree of similarity.

The degree of similarity may include an assessment of the following:

1. Product similarity (the trademark in controlled and uncontrolled transactions should be used in association with similar products or processes within the same general industry or market)
2. Profit potential (taking into consideration growth expectations)
3. Form of the royalty payment (e.g., lump-sum amount or running royalty)
4. Duration of the trademark license
5. Restrictions (e.g., exclusivity, geographical area or territorial limitations, and market limitations)
6. Stage of development
7. Collateral transactions or ongoing business relationships between the transferor and transferee (e.g., joint venture arrangements, cross-licensing arrangements, or the exchange of other intangible property or services as part of the transaction)

Generally, comparable trademark license transactions are those involving a similar product or business to that of the subject trademark with similar license terms, particularly with regard to the structure of the royalty (e.g., a lump-sum amount versus annual royalty payments) and restrictions of use (e.g., exclusivity).

Even after identifying reasonably comparable trademark licenses, some dissimilarity can remain. So the selected royalty rate may be adjusted to fit the particular facts and circumstances surrounding the subject trademark. Some factors that analysts often consider in the adjustment of the royalty rate are presented in Table 1.[5]

Income Approach

Income approach methods are often used in trademark valuation. There are various income approach valuation methods used in practice.

These methods commonly estimate the value of a trademark by calculating the present value of future income streams expected to be generated by use of the trademark over its remaining useful life (RUL). The methods generally differ in how those income streams are determined.

The various income approach methods typically employ one or more of the following types of income analysis:

1. Relief from Royalty Income—Commonly used methodology that assumes that if a corporation owns a trademark, then it is relieved from paying a royalty, so a hypothetical royalty payment can be estimated. This analysis is also characterized under the market approach and is described in more detail in that section of this discussion.
2. Profit Split (or Residual Profit Split) Income—The total income that a trademark owner or licensee is expected to generate from use of the trademark over its RUL is allocated (or split) between the trademark and all the other tangible and intangible property that contribute to generating the income.
3. Incremental Income—The income indicative of the value of a trademark is estimated as the difference between (a) the amount of income that the owner or licensee would be expected to generate with the use of the trademark and (b) the amount of income that the owner or licensee would be expected to generate without the use of the trademark.
4. Residual (or Excess) Income—The income estimated to be generated from the use of a trademark is estimated by subtracting from the total income of the owner or licensee a capital charge on contributory assets, which reflects the fair rate of return on all identifiable tangible and intangible property.

Intercompany Transfer Price Methods

Transfer pricing methods reflect a specialized area of valuation that follows the Internal Revenue Code and the related regulations. The Section 482 regulations require the transfer price analyst to apply the “best method” rule in allocating taxable income between related parties in certain transactions.

The best method rule stipulates that the arm’s-length result of a controlled transaction should be determined under the method that, under the facts

Table 1
Factors Considered in the Adjustment of the Royalty Rate

Item	Factor	Consideration
1	Age, absolute	Long established or newly created trademark
2	Age, relative	Older or newer than competing trademarks
3	Use, consistency	Used consistently on related products or inconsistently on unrelated products
4	Use, specificity	Used on a broad range of products and services vs. narrow range
5	Use, geography	Has wide appeal (e.g., can be used internationally) vs. narrow or local appeal
6	Potential for expansion	Unrestricted vs. restricted ability for use on new and different products
7	Potential for exploitation	Unrestricted vs. restricted ability for licensing in new industries and uses
8	Associations	Trademark associated with positive vs. negative person, event, or location
9	Connotations	Name has positive vs. negative connotations and reputation among consumers
10	Timeliness	Trademark is perceived as modern vs. old-fashioned
11	Quality	Trademark is perceived as respectable vs. less respectable
12	Profitability, absolute	Profit margins on associated products is higher vs. lower than industry average
13	Profitability, relative	Profit margins on associated products is higher vs. lower than competitor(s)
14	Expense of promoting	Low vs. high cost of advertising and marketing of trademark
15	Means of promoting	Numerous vs. few means to promote the trademark
16	Market share, absolute	Associated product has high vs. low market share
17	Market share, relative	Associated product has higher vs. lower market share than competitor(s)
18	Market potential, absolute	Products are in an expanding vs. contracting market
19	Market potential, relative	Market for products expanding faster vs. slower than competitor(s)
20	Name recognition	Trademark has high vs. low recognition among consumers

and circumstances, provides the most reliable measure of that result.

Three transfer pricing methods are specified in the Section 482 regulations: the CUT method, the profit split method, and the comparable profits method.[6]

The analyst is permitted under the Section 482 regulations to use an unspecified method if any of the specified methods would not yield the most reliable measure under the circumstances.

The CUT method and profit split method generally follow the same principles as the relief from royalty method under the market approach and the profit split analysis under the income approach, respectively.

The comparable profits method evaluates the arm's-length result of a controlled transaction based on objective measures of profitability (known as profit-level indicators, or PLIs) derived from uncontrolled taxpayers that engage in similar business activities under similar circumstances.

With regard to cost-sharing arrangements, an income method is also specified.[7]

The income method was introduced as part of the revised cost-sharing regulations adopted in 2009. This method measures the value of the subject trademark (as a platform contribution under a cost sharing arrangement) as the difference of the profits that the party that did not develop the trademark expects to realize as a participant to the cost sharing arrangement and the profits it would expect to earn under a "realistic alternative."

As the name implies, the method follows the income approach and is a form of incremental income analysis.

Remaining Useful Life

RUL is a deceptively simple notion. It reflects the period during which a trademark is expected to contribute directly or indirectly to the owner's or

licensee's future cash flow. It may be shorter than the legal or statutory life of the trademark. The general concept of the RUL was introduced earlier in this discussion, but it warrants further discussion here.

Determining the RUL of a trademark is integral to determining its value under all three generally accepted valuation approaches.

Using the cost approach, the RUL of the trademark is a consideration when estimating obsolescence factors.

Using the market approach, the RUL of the guideline trademark assets is a factor of consideration for comparability when selecting and applying those guideline assets.

And using the income approach, the RUL directly influences the timing and duration of future cash flow expected to be generated by the trademark.

The RUL also affects how the value of the trademark is adjusted over time for financial accounting purposes. A trademark with a definite RUL is amortized over that period. A trademark with an indefinite RUL is not amortized; rather, it is periodically tested for impairment.

It is a simplifying assumption often made by valuation analysts and other practitioners that the RUL of a trademark is indefinite so long as the company using the trademark expects to use (and maintain) it in the foreseeable future. It is not advisable, however, to naively accept this assumption in lieu of further inquiry.

Reilly and Schweihs (2013) explain that estimating the RUL of a trademark involves an analysis of a number of pertinent factors,[8] including the following:

1. The expected use of the trademark by the owner or licensee. Where use is closely tied to a particular product or service line, the life cycle of the associated products or services should be considered.
2. The expected useful life of another asset or group of assets to which the useful life of the trademark may relate.
3. Any legal, regulatory, or contractual provision that may limit the useful life. A license to use a trademark, for example, generally restricts the useful life to the term of the license, though the option for renewal and the likelihood of exercising that option are also factors to consider.
4. The historical experience of the owner in extending the right to use the trademark and the licensee in renewing such right. Note that market participants would consider the highest and best use of the trademark when making assumptions regarding renewals or extensions.
5. The effects of obsolescence, demand, competition, and other economic factors.
6. Regular maintenance expenditures that would be required to support the expected future cash flow from the trademark. More than maintenance fees for the trademark registration, these expenditures typically include the advertising and marketing required to maintain the impression of the trademark in the mind of the consumers from whom the future cash flow depends.

In addition, Smith and Parr (2005) explain obsolescence as four distinct factors that influence the RUL of a trademark. These four types of obsolescence are presented with added commentary, as follows:[9]

1. Functional obsolescence: Trademarks suited for specific purposes typically have shorter remaining useful lives than those suited for more general purposes because the risk of obsolescence increases at greater levels of specificity. A trademark associated with an iPad product will tend to have a shorter RUL than a trademark for Apple.
2. Economic or event obsolescence: The remaining useful life of a trademark may be affected by economic circumstances or events outside the course of normal trademark activities. Examples of such events include legislative action affecting the regulatory environment and natural disasters causing long-term disruptions in manufacturing or distribution.
3. Technological obsolescence: A trademark can suffer technological obsolescence when it is tied closely to a product or service with a high risk of being substituted for more technologically advanced products or services. The value of trademarks associated with Smith Corona typewriters rapidly diminished as computer-based word processors became commonplace.
4. Cultural obsolescence: Cultural issues may affect the trademark's remaining useful life. For example, a trademark may become obsolete because it is politically incorrect or offensive. Lay's retired its "Frito Bandito" trademark in the 1970s after complaints

that the trademarked mascot invoked an unflattering "Mexican bandit" stereotype—replete with gold teeth and guns—to steal corn chips in Frito's advertisement.

There exist some examples of trademarks that appear to have indefinite remaining useful lives. The Coca-Cola trademark is more than 120 years old, and the Coca-Cola Company may well continue to maintain the market for its sugary drinks for another 120 years.

On the one hand, the uncertainties of forecasting cash flow far into the future are mitigated by discounting the cash flow to its present value. For example, using a discount rate of 10 percent, the present value of $1,000 earned 120 years from now is one penny—less than a rounding error.

Given the amount of discounting, it seems immaterial to our valuation if Coca-Cola instead earns $700 during that future year, as the difference is a fraction of a penny on a present value basis.

On the other hand, there exist many examples where the expectations of companies are undermined by significant shifts in the market that can occur abruptly.

On April 2, 1993, one of the most famous and valuable brands in the world, Marlboro, announced it would reduce its prices permanently by 20 percent to cope with the emerging competition from cheaper, generic brands. The date become known as "Marlboro Friday," and it was heralded as a watershed moment in marketing history.

Marlboro was an iconic brand and boasted the longest running advertising campaign in history, the Marlboro Man having been launched in 1954. Philip Morris, the owner of the Marlboro trademarks, saw its stock price plummet 23 percent in one day, knocking $13 billion off the value of the company.

From one perspective, the $13 billion loss could be attributed in large portion to a reduction in the value of the Marlboro trademarks.

The repercussions of Marlboro Friday reverberated into other industries. Companies with well-known trademarks such as Proctor & Gamble collectively lost tens of billions of dollars that same day.

The rationale behind the loss was that if a premier product like Marlboro, with a trademarked name and image that had been carefully bred and bolstered by more than a billion dollars in advertising investments over many years, was reduced to competing on price with generic brands, then the strategy of relying on trademarks to support premium pricing was placed in doubt.

It shows that trademarks can suffer severe obsolescence despite diligent efforts to maintain them.

Other studies suggest that, on the whole, the useful life of trademarks tends to be getting shorter, further signaling that caution should be taken in assuming an indefinite useful life for valuation or other analytical purposes.

This is likely a result of shortened product life cycles, shortened trademark license periods, shortened duration of advertising effects, and an increasing rate of obsolescence, among other things, that are increasingly characteristic of today's global, technology-infused, highly competitive markets.

Stangler and Arbesman (2012) report that the average duration of companies in the Fortune 500 has been decelerating over the past few decades.[10] Of the companies listed in the Fortune 500 at the beginning of 1955, only about 170 remained in 1990, resulting in a turnover of 330 companies over 35 years, or about 9 companies per year.

By 1995, the turnover rate had accelerated and 220 companies remained in 2010, resulting in a turnover of 280 companies over 15 years, or about 19 companies per year. Hence, between 1955 and 2010, the turnover rate of companies in the Fortune 500 effectively doubled.

The increasing turnover points to decreasing useful lives for trademarks as the lives of the underlying businesses are shortening.

This is similar to the turnover observed by Bruner (2005), who reports that of the 501 firms listed on the New York Stock Exchange in 1925, only 65 (or 13 percent) remained in 2004.[11]

Let's consider Eastman Kodak, for example. Founded in 1880, it reigned as one of America's great technology companies for over a century—one of the bluest of the blue chips.

Despite inventing the digital camera to succeed its successful but aging film business, the relatively sudden emergence of smartphones with integrated digital cameras in the late 2000s triggered a collapse in Kodak's sales. In 2010, it was removed from the S&P 500 to make way for newer companies like Netflix.

In another study, MARKABLES, an aggregator of trademark license agreements, analyzed the useful lives asserted in the valuations of 4,500 trademarks and brands between 2003 and 2013.[12]

The MARKABLES study concluded that there has been a strong shift towards the assertion of definite useful lives in trademark valuations, and the definite useful lives are getting shorter. In 2003, trademarks with definite useful lives accounted for little less than 20 percent of all valuations.

By 2013, the portion increased to around 60 percent. Further, the average remaining useful life fell to 10.7 years in 2013 from 12.5 years in 2003. This finding is consistent with earlier studies, such as a study published in *Tax Executive* in which 57 trademark license agreements were examined, and the average duration was found to be less than 10 years.[13]

In the tax-related transfer pricing context, there are further considerations for assessing the RUL of a trademark. The interpretation of tax regulations can affect this assessment, and two issues are particularly noteworthy:

1. Internal Revenue Code Section 367(d)
2. Whether a cost-sharing arrangement (CSA) for a subject trademark is treated under the Section 482 regulations as the transfer of a preexisting asset for the purpose of calculating a buy-in payment

With regard to Section 367(d), Congress enacted the regulation to ensure that U.S. corporations are unable to avoid income taxes by transferring certain intangible assets to low-tax foreign jurisdictions after claiming significant expenses on U.S. tax filings for the development of those intangible assets.[14]

It requires the transferor to include as income an appropriate arm's-length charge for the transferee's use of a transferred intangible property over its RUL. Importantly, Section 367(d) limits the RUL to 20 years.

Given the commonalities of the Section 367(d) purpose to Section 482, and because Section 367(d) is used by the Internal Revenue Service (the "Service") as a backstop to Section 482,[15] some analysts advocate applying the 20-year RUL limitation to analyses performed under Section 482.

While the RUL limitation under Section 367(d) lends theoretical support to the reasonableness of asserting a definite useful life under Section 482, the Service has provided no validation of this position and, to the contrary, has applied an indefinite RUL under Section 482 transfer price analysis in recent tax cases.

With regard to the issue of a CSA buy-in payment, revised cost-sharing regulations were adopted in 2009 to provide for an "investor model" approach that frames the subject intangible property as an ongoing development activity rather than a one-time transfer of a preexisting intangible property.

The modified provisions under Section 482, therefore, appear to offer the Service more substantive grounds for assuming an indefinite RUL with regard to transactions determined under the new regulations.

For transactions conducted under the previous regulations, the application of an indefinite RUL for a buy-in payment was found to be inconsistent with the provisions of Section 482, as written at the time.

In *Veritas Software Corp. v. Commissioner*,[16] the Tax Court rejected the Service's assertion of an indefinite RUL in that matter, holding that Section 482 required only that participants make a buy-in payment with respect to the preexisting intangible property actually transferred, not subsequently developed intangible property.

The rationale was that subsequent development and maintenance costs would be borne by participants under the CSA and the buy-in payment was intended to address only the market value of the asset developed up to the time of the transaction.

In short, determining the RUL of a trademark involves consideration of a number of pertinent factors beyond its intended use by the current owner or licensee. These factors include legal, regulatory, or contractual provisions that may limit the useful life, as well as the effects of obsolescence and other economic factors.

Illustrative Examples of a Trademark Valuation

This section presents three simple trademark valuation examples.

Example 1 presents a trademark valuation for financial accounting purposes using the relief from royalty method of the market approach.

Example 2 presents a trademark valuation for financial accounting purposes using the residual profit split method of the income approach.

Exhibit 1
Alpha Company
Selected Comparable Uncontrolled Transactions
Trademark License Summary

#	Licensor	Licensee	License Start Year	License Term (Years)	General Industry	Specific Industry	Degree of Exclusivity	Royalty Low	Royalty High	Other Fee
1	Merchandising Corp. of America, Inc.	Sports Archives, Inc.	2010	10	Specialty Stores	SIC Code 59	Exclusive	1.0%	1.0%	N/A
2	Kmart Corporation	Kmart Australia Limited	2011	10	Department Stores	SIC Code 53	Exclusive	0.5%	1.5%	N/A
3	Trader International Corporation	Kheeler Specialty Stores, Inc.	2013	10	Specialty Stores	SIC Code 59	Exclusive	3.0%	3.0%	$2 M minimum
4	Rampage Licensing LLC	Charlotte Russe Merchandising, Inc.	2010	10	Specialty Stores	SIC Code 59	Exclusive	1.0%	3.0%	N/A
5	Toys "R" Us, Inc.	The Right Start, Inc.	2013	10	Specialty Stores	SIC Code 59	Exclusive	0.3%	0.5%	N/A
6	The Sports Authority, Inc.	Mega Sports Co., Ltd.	2011	10	Sporting Goods	SIC Code 59	Exclusive	2.0%	2.0%	N/A
7	Fila Sport S.P.A.	Renaissance Golf Products, Inc.	2012	10	Sporting Goods	SIC Code 59	Exclusive	0.8%	1.5%	N/A

	Low	High
Low	0.3%	0.5%
High	3.0%	3.0%
Median	1.0%	1.5%
Mean	1.2%	1.8%

Selected Trademark License Royalty Rate 1.5%

Exhibit 2
Alpha Company
Trademark Valuation
Market Approach Relief from Royalty Method
Valuation Summary
As of January 1, 2015

	Projected Fiscal Years Ending December 31				
	2015 $000	2016 $000	2017 $000	2018 $000	2019 $000
Projected Net Revenue Attributed to the Trademark [a]	10,800	11,340	11,907	12,502	13,127
Market-Derived Trademark License Royalty Rate [b]	1.5%	1.5%	1.5%	1.5%	1.5%
Pretax Avoided Trademark License Royalty Expense	162	170	179	188	197
Less: Income Tax (at 40%)	65	68	71	75	79
After-Tax Avoided Trademark License Royalty Expense	97	102	107	113	118
Discounting Period [c]	0.5	1.5	2.5	3.5	3.5
Present Value (PV) Factor (at 12%) [d]	0.9449	0.8437	0.7533	0.6726	0.6726
PV of After-Tax Avoided Trademark License Royalty Expense	92	86	81	76	79
Indicated Fair Value of Trademark	**414**				

Notes:
[a] Based on projections provided by Alpha management
[b] Based on an analysis of CUT trademark license agreements. See Exhibit 1
[c] Based on the midyear convention, payment of the royalty is assumed to occur in the middle of the fiscal year
[d] Based on the weighted average cost of capital (WACC) for Alpha Company

And, example 3 presents a trademark buy-in price analysis for a tax-related intercompany transfer pricing purpose using the comparable uncontrolled transactions method.

Example 1—Relief from Royalty Method

Let's assume that Alpha Company ("Alpha") is an Internet-based retailer of consumer household and sporting goods. Alpha acquired a license to use the "WhooHoo!" trademark as part of its acquisition of Beta Company ("Beta") on January 1, 2015. Beta originally licensed the trademark from another company.

As part of a purchase price allocation governed by ASC topic 805, Alpha is required to identify and report the trademark at fair value. The date of the valuation is January 1, 2015.

Let's assume the trademark license expires five years from the date of acquisition and Alpha does not expect the licensor to renew it. Thus, the RUL of the trademark is five years.

Alpha management provided five-year revenue projections for products sold in association with the trademark, as well as estimated selling, general, and administrative expenses. Let's further assume that the appropriate effective income tax rate for Alpha is 40 percent and the analyst determined

Exhibit 3
Alpha Company
Trademark Valuation
Income Approach
Illustrative Profit Split Analysis
Valuation Summary
As of January 1, 2015

	Projected Fiscal Years Ending December 31,				
	2015	2016	2017	2018	2019
	$000	$000	$000	$000	$000
Projected Net Revenue Attributed to the Trademark [a]	10,800	11,340	11,907	12,502	13,127
Gross Profit Margin [b]	21.5%	21.5%	21.5%	21.5%	21.5%
Gross Profit (Revenue less Cost of Goods Sold)	2,322	2,438	2,560	2,688	2,822
Less: Selling, General, and Administrative Expenses [b]	1,858	2,024	2,125	2,150	2,258
Income Before Taxes	464	414	435	538	564
Less: Income Tax (at 40%)	186	166	174	215	226
After-Tax Income	278	248	261	323	338
Less: Contributory Asset Charges	70	62	65	81	85
Residual Income	209	186	196	242	254
Market-Derived Royalty Proft Split [c]	50%	50%	50%	50%	50%
Royalty Payment to Trademark Owner	104	93	98	121	127
Discounting Period [d]	0.5	1.5	2.5	3.5	3.5
Present Value Factor (at 12%) [e]	0.9449	0.8437	0.7533	0.6726	0.6726
Present Value of Royalty Payment	99	78	74	81	85
Indicated Fair Value of Trademark [f]	**417**				

Notes:
[a] Based on projections provided by Alpha management.
[b] Based on historical financial results and Alpha management estimations.
[c] Based on comparable public guideline license agreements indicating that a 50 percent residual profit split is appropriate.
[d] Based on the midyear convention, payment of the royalty is assumed to occur in the middle of the fiscal year.
[e] Based on the weighted average cost of capital (WACC) for Alpha Company.
[f] Ignores the value increment associated with the tax amortization benefit (TAB) only for purposes of simplifying this example.

the appropriate present value discount to be 12 percent.

The analyst performed extensive market research to identify CUT trademark license agreements, as summarized in Exhibit 1.

The analysis of these selected comparable license agreements indicated that the market-derived royalty rate appropriate for the "WhooHoo!" trademark is 1.5 percent. Accordingly, the analyst concluded that it would be appropriate to employ the market approach relief from royalty method.

A simplified example of the relief from royalty method is presented in Exhibit 2.

The selected royalty rate was applied annually to the net revenue to arrive at a pretax avoided royalty expense, which was then adjusted for income taxes. The resulting after-tax avoided royalty expense is tantamount to an income stream. This is because it reflects license royalty payments saved by owning the trademark.

The present value of the sum of this annual avoided royalty expense represents the fair value of the trademark, which the analyst concluded was $414,000 as of January 1, 2015.

Example 2—Profit Split Income Analysis

The same facts provided in Example 1 apply in this example, except that the analyst also concluded that it would be appropriate to employ the income approach residual profit split method.

For the present example, let's define the "profit split" residual income as:

	Net revenue
Less:	Cost of goods sold
Equals:	Gross profit
Less:	Selling, general, and administrative expenses
Equals:	Net income
Less:	Contributory asset charges
Equals:	Residual income

Let's assume that for each year the analyst appropriately determined the capital charge on contributed assets, reflecting the required rate of return on other identifiable intangible assets that contributed to the generation of income.

The analyst performed extensive market research to identify comparable trademark license agreements, including the agreements presented in Exhibit 1.

The analysis of these license agreements (not presented) indicated that the appropriate royalty rate for the "WhooHoo!" trademark would be a profit split of residual income of approximately 50 percent.

That is, in a typical agreement, the licensor receives 50 percent of the licensee's income attributable to the trademark, and the licensee receives the remaining 50 percent. The indicated profit split for a license agreement is either explicitly provided or implicitly derived from the terms of the agreement in view of the respective licensee's historical financial performance.

The residual (or excess) income—the income attributable to the trademark—is determined by deducting from gross profit the operating expenses, the income taxes, and the charge.

A simplified example of the profit split method is presented in Exhibit 3.

For financial accounting (particularly ASC 805) purposes, all income approach intangible asset valuations incorporate a tax amortization benefit (TAB) adjustment. Only for the purpose of simplifying this example, the calculation of the TAB value increment was left out of this illustrative example.

As presented in Exhibit 3, the 50 percent profit split royalty rate applied to the residual income reflects the portion of income that Alpha is able to generate annually as a benefit of using the subject trademark.

The present value of this income stream represents the fair value of the trademark, which the analyst concluded was $417,000 as of January 1, 2015.

Synthesis of Examples 1 and 2

A synthesis of the relief from royalty method and the profit split method is method is presented in Exhibit 4.

As presented in Exhibit 4, the valuation synthesis and conclusion reflects a weighted average of the market approach presented in Exhibit 2, and the income approach shown in Exhibit 3. After considering the relative strengths and weaknesses of the two valuation approaches under the facts and circumstances, the analyst concluded that the synthesis would be calculated as 50 percent of the value determined by each approach.

Accordingly, the indicated fair value of the "WhooHoo!" trademark was determined to be $415,000 as of January 1, 2015.

Exhibit 4
Alpha Company
Trademark Valuation
Value Synthesis and Conclusion
As of January 1, 2015

Valuation Approach	Valuation Method	Emphasis	Value Indication $000	Reference
Market approach	Relief from royalty method	50%	414	Exhibit 2
Income approach	Profit split method	50%	417	Exhibit 3
	Trademark Fair Value Conclusion		**415**	

Example 3—Buy-In Price Analysis

Changing gears to tax-related transfer pricing, let's assume that Alpha, a U.S. company, has entered into a CSA with its wholly owned foreign subsidiary Delta Company ("Delta"), to develop a trademark.

In a CSA, the parties share the costs of developing and maintaining intangible assets, including trademarks, in proportion to each party's share of anticipated benefits from the cost-shared intangible assets.

This agreement allows Delta to use the subject trademark by paying a share of the development costs rather than paying a royalty to Alpha, which lowers the overall income taxes paid because Alpha is in a higher tax jurisdiction than Delta. Delta is located in Ireland.

Based on the Section 482 regulations and the relevant facts and circumstances, the analyst concluded that the CUT method would be the best method for determining the buy-in price that Delta would pay Alpha under the tax-related transfer pricing rules.

The analyst performed extensive market research to identify CUT license agreements, as presented in Exhibit 1. After considering all relevant factors, particularly with respect to the similarity of the terms and circumstances of the CUT license agreements to the subject transaction, the analyst concluded that an appropriate arm's-length price royalty rate for the subject trademark would be 1.5 percent of net revenue.

A simplified example of the CUT method is presented in Exhibit 5.

While the determination of the buy-in price in Exhibit 5 is similar in many ways to the relief from royalty method illustrated in Example 1, there are two important differences.

Exhibit 5
Alpha Company
Trademark Valuation
Buy-In Price Analysis
Valuation Summary
As of January 1, 2015

	Projected Fiscal Years Ending December 31,				
	2015 $000	2016 $000	2017 $000	2018 $000	2019 $000
Projected Net Revenue Attributed to the Trademarks [a]	10,800	11,340	11,907	12,502	13,127
Arm's-Length Trademark License Royalty Rate [c]	1.5%	1.5%	1.5%	1.5%	1.5%
Gross Pretax Trademark License Royalty Income	162	170	179	188	197
Less: Trademark License Expense [d]	108	113	119	125	131
Net Pretax Trademark License Royalty Income	54	57	60	63	66
Discounting Period [e]	0.5	1.5	2.5	3.5	3.5
Present Value (PV) Factor (at 12%) [f]	0.9449	0.8437	0.7533	0.6726	0.6726
PV of Pretax Trademark License Royalty Income	51	48	45	42	44
Sum of PV of Pretax Trademark License Royalty Income	230				
Valuation Summary					
PV of Discrete Period Trademark License Royalty Income	230				
Indicated Buy-In Price of the Trademark	**230**				

Notes:
[a] Based on projections provided by Alpha management.
[b] Based on an analysis of CUT trademark license agreements. See Exhibit 1.
[c] Projected license expense relating to maintaining, promoting, and protecting the subject trademarks into perpetuity.
[d] Based on the midyear convention, payment of the royalty is assumed to occur in the middle of the fiscal year.
[e] Based on the weighted average cost of capital (WACC) for Alpha Company.

First, under the tax-related intercompany transfer pricing rules, the buy-in price is calculated using pretax income, whereas the value indicated by the relief from royalty method is tax-affected.

Second, the buy-in price in the present example assumes a five-year RUL.

In determining the buy-in price, the analyst first adjusted the gross royalty income by deducting the cost of maintaining the trademark through advertising and other promotional activities in order to ward off obsolescence. The present value of the resulting pretax income yielded the value of the subject trademark for the discrete period of 2015 through 2019.

Based on the illustrative analysis, the analyst concluded that the indicated buy-in price of the subject trademark was $230,000 as of January 1, 2015.

Summary and Conclusion

This discussion introduced the valuation of trademarks. It first described the factors that are relevant to the identification and valuation of trademark-related intangible property.

Second, this discussion explained the generally accepted trademark valuation approaches and methods, particularly within the context of financial reporting and transfer pricing.

Third, this discussion described determining the remaining useful life of a trademark with respect to the various contexts.

Finally, this discussion presented three simple examples, using different analytical methods, to illustrate the valuation of trademark intellectual property.

As is the case with valuing other intangible property, it is important for the analyst to consider the generally accepted approaches and methods in view of the trademark intellectual property rights actually being valued, the economic environment in which the owner and/or licensee operate, and the facts and circumstances surrounding the use of the subject trademark.

Notes:

1. See 15 U.S.C. §1127.
2. Ibid., §1052.
3. See, generally, 26 CFR §1.482.
4. Ibid., 1.1482-1(b)(1).
5. See, for example, Robert F. Reilly and Robert P. Schweihs, *Guide to Property Tax Valuation*, (Chicago: Willamette Management Associates Partners, 2008), Exhibit 21-1.
6. See 26 CFR §1.482-4.
7. Ibid., 1.482-7.
8. See Robert F. Reilly and Robert P. Schweihs, *Guide to Intangible Asset Valuation* (New York: American Institute of Certified Public Accountants 2014), Chapter 21.
9. See Gordon V. Smith and Russel L. Parr, *Intellectual Property: Valuation, Exploitation, and Infringement Damages* (New York: John Wiley & Sons, 2005), Chapter 11.3.
10. Dane Stangler and Sam Arbesman, "What Does Fortune 500 Turnover Mean?" Ewning Marion Kauffman Foundation study, www.kauffman.org (2012).
11. Robert F. Bruner, *Deals from Hell: M&A Lessons That Rise Above the Ashes* (New York: John Wiley & Sons, 2005).
12. See "The Useful Life of Trademarks," MARKABLES Bulletin #1, www.markables.net (2014).
13. See McShan, Merwin, Stone, and Wright, "A Review of Third-Party License Agreements: Are Periodic Adjustments Arm's Length?," *Tax Executive* (July-August 1989).
14. See IRS Technical Advice Memorandum 200907024 dated February 13, 2009.
15. See IRC 1.376(d)-1T(g)(4).
16. See Veritas Software Corp. v. Commissioner, 133 T.C. 297 (2009).

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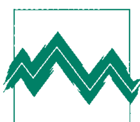

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Estimating Intercompany Transfer Price Trademark Royalty Rates

John C. Ramirez

Valuation analysts are often called on to estimate an arm's-length price trademark royalty rate as part of a tax-related intercompany transfer price analysis. This discussion summarizes the regulations that govern transfer pricing for federal income tax purposes, and it describes the factors that analysts and (other transfer pricing practitioners) often consider when estimating intercompany transfer price royalty rates. This discussion focuses on the methods and procedures used to estimate a trademark royalty rate and on the facts and circumstances that affect the pricing of trademark royalty rates for tax-related intercompany transfer price purposes.

Introduction

Trademarks, trade names, and brand names are valuable intangible property that are frequently transferred (or licensed) from one related entity to another related entity.

Intangible property transfer price analyses are performed for various purposes, including the following:

1. Cost accounting within multi-business unit consolidated corporations (particularly when company employees are compensated based on business unit profitability)
2. Cost accounting between wholly owned subsidiaries and less than wholly owned subsidiaries (particularly when the wholly owned subsidiary parent controls the accounting)
3. Intangible property transfers between a for-profit entity and a related not-for-profit entity (for example, the license of a not-for-profit hospital's trademark to a for-profit medical practice subsidiary)
4. The license of intellectual property (IP) between operating companies and a related IP holding company (which has state and local income tax implications)
5. Intangible property and services transfers between close corporations owned by the parent corporation and the children generation (which has federal gift and estate tax implications)
6. The intercompany transfer of intangible property between international subsidiaries of a multinational parent corporation (which is the topic of this discussion)

For U.S. income tax purposes, these related-party transactions are regulated by the Internal Revenue Service (the "Service") according to the Internal Revenue Code Section 482 and the associated Treasury Regulations (the "Section 482 regulations").

In recent years, the Service increased its scrutiny of this common intangible property transfer price arrangement. This is because the Service is concerned that a domestic taxpayer could avoid domestic taxes by transferring property, and allocating the associated income, to a related foreign entity located in a lower-tax-rate country.

From a valuation prospective, trademark royalty rates are typically one of the most hotly contested aspects involved in a transfer pricing dispute. The key to developing credible and defensible transfer

> **"The standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer."**

pricing trademark royalty rates is to provide a thorough comparability analysis of the relevant functions and risks associated with the transferred trademarks and to develop an accurate understanding of the relevant financial information.

In addition, it's important that analysts have a clear understanding of the regulations and the general factors and circumstances that affect the pricing of trademark royalty rates.

First, this discussion presents an overview of the Section 482 regulations that govern the transfer pricing of trademarks. Second, this discussion focuses on the methods and procedures used to estimate trademark royalty rates and the factors and circumstances that analysts often consider when selecting a trademark royalty rate for transfer pricing purposes.

Overview of Section 482 Regulations and the Arm's-Length Price Standard

When estimating a trademark royalty rate as part of an intercompany transfer pricing engagement for federal income tax purposes, analysts should work closely with counsel to develop a thorough understanding of the Section 482 regulations.

The purpose of Section 482 is to ensure that taxpayers clearly reflect the income attributable to controlled transactions.[1]

The standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer.[2] A controlled transaction meets the arm's-length price 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 or comparable transaction under the same or comparable circumstances.[3] Typically, U.S. courts and other transfer pricing practitioners equate the arm's-length price of a property to be the fair market value of the property at the time of the transaction.

For purposes of Section 482, "controlled includes any kind of control, direct or indirect, whether legally enforceable or not, and however exercisable or exercised, including control resulting from the actions of two or more taxpayers acting in concert or with a common goal or purpose."[4]

Because Section 482 is applied by comparing the subject controlled transaction to a similar uncontrolled transaction, the arm's-length price standard and the comparability test give Section 482 a market orientation that requires the examination of:

1. the facts and circumstances relevant to the controlled transaction and
2. the facts and circumstances relevant to the uncontrolled transactions used to test the arm's-length result of the controlled transaction.

The comparison between controlled transactions and uncontrolled transactions is performed on actual results (i.e., real transactions between unrelated parties) over a similar time period. Similarity of the controlled transactions to comparable uncontrolled transactions in one period does not indicate that this similarity holds in other periods.

Periodic comparability tests are therefore typically performed to confirm that the controlled transactions correctly reflect the economic and business realities of a given set of transactions.

The following section describes the various tax-related intangible property transfer price methods permissible under the Section 482 regulations and the criteria that analysts should consider when selecting the best method.

Intangible Property Transfer Price Methods

For purposes of Section 482, the arm's-length price of intangible property should be commensurate with the income attributable to the intangible property.[5]

There are four intangible property intercompany transfer price methods specified under the Section 482 regulations:

1. The comparable uncontrolled transaction (CUT) method
2. The comparable profits method (CPM)
3. The profit split method (PSM)
4. Unspecified methods[6]

Comparable Uncontrolled Transaction (CUT) Method

The CUT method evaluates whether the amount charged for a controlled transfer of intangible property was at arm's length by reference to the amount charged in a comparable uncontrolled transaction.

That is, the CUT method compares a controlled transaction to similar uncontrolled transactions to provide a direct estimate of the price the parties would have agreed to had they resorted directly to a market alternative to the controlled transaction.[7]

The Section 482 regulations allow for application of the CUT method both where the comparable transaction involves the same intangible property under substantially the same circumstances as the controlled transfer and, absent such evidence, when the comparable transactions involve comparable intangibles under comparable circumstances.

One factor in a CUT method analysis is to determine 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 or comparable transaction under the same or comparable circumstances.

The intangible property transferred in an uncontrolled transaction is generally considered to be comparable to that transferred in the controlled transaction if both intangible properties are used in connection with:

1. similar products or processes
2. within the same general industry or market, and
3. have similar profit potential.[8]

Inexact comparable transactions (i.e., similar transactions) are permitted under the Section 482 regulations because truly identical transactions are rare. Similar intangible property license transactions, however, occur more frequently and such royalty data are widely available.

If material differences exist between the controlled and uncontrolled transactions, adjustments should be made to the results of the uncontrolled transactions if the effect of such differences on price or profits can be ascertained with sufficient accuracy to improve the reliability of the results.

Comparable Profits Method (CPM)

The CPM evaluates whether the amount charged in a controlled transaction is at 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.

Profit Split Method (PSM)

The PSM evaluates whether the allocation of the combined operating profit or loss attributable to a controlled transaction is arm's-length by reference to the relative value of each controlled taxpayer's contribution to that combined profit or loss.

The combined operating profit or loss should be derived from the most narrowly identifiable business activity of the controlled taxpayers.

Unspecified Method

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. Such taxpayers will only enter into a particular transaction if there are no better alternatives.

To the extent that this method relies on internal data rather than on uncontrolled comparables, its reliability will be reduced.

According to the Section 482 regulations, there is no strict priority to which method is used, and no method will invariably be considered to be more reliable than others. In addition, each of the methods must be applied in accordance with all of the provisions of the Section 482 regulations, including the best method rule and the arm's-length price standard.

Best Method Rule

The Section 482 regulations require that arm's-length considerations for intercompany transactions be determined using the best method rule. The best method rule states that "the arm's length result of a controlled transaction must be determined under the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result."[9]

The best method is the pricing method that provides the most reliable measure of an arm's-length result, based on the following:

1. The degree of comparability between the controlled transaction (or taxpayer) and any uncontrolled comparable transactions
2. The quality of the data and assumptions used in the analysis

The degree of comparability between controlled and uncontrolled transactions should be evaluated considering all factors that could affect comparability under a particular transfer price method.

The five factors typically used to determine the degree of comparability include the following:

- Functions performed
- Risks assumed

- Contractual terms
- Economic conditions
- Nature of the property or services

To determine the quality of the data and the assumptions used in the analysis, the following factors are typically considered:

- Completeness and accuracy of the data
- Reliability of assumptions
- Sensitivity of the results to deficiencies in data and assumptions

For purposes of the best method rule, analysts consider each of the methods specified in the regulations to determine which method is most reliable in consideration of the fact pattern and the availability and reliability of the existing data.

Although the regulations at times indicate a preference for transactional methods, an arm's-length result may be determined under any method without establishing the inapplicability of another method. Thus, it is important that analysts apply the best method rule to determine the best method for a particular trademark transfer price analysis.

If comparable market transactional data are available, the CUT method is often the best method for trademark transfer price analyses.

This is because, in most cases, the availability of comparable trademark license transactions (i.e., market based transactional data) provides the most defensible/reliable evidence of an arm's-length result.

Because the CUT method is typically selected as the best method to estimate a trademark transfer price, this discussion focuses on estimating trademark royalty rates for application in a CUT method trademark valuation analysis.

Defining the Subject Intangible Property

An initial procedure in estimating trademark royalty rates is the identification of the subject property. Trademarks are one type of intangible property.

For purposes of Section 482, intangible property is considered to be property that comprises any of the following items and has substantial value independent of the services of any individual:

1. Patents, inventions, formulae, processes, designs, patterns, or know-how
2. Copyrights and literary, musical, or artistic compositions
3. Trademarks, trade names, or brand names
4. Franchises, licenses, or contracts
5. Methods, programs, systems procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data
6. Other similar items

An item is considered similar to those listed here if it derives its value not from its physical attributes but from its intellectual content or other intangible property.[10]

The above listed intangible property can be transferred as a single asset or as a bundle of assets. It is, therefore, important for analysts to identify exactly what property was transferred and what property is being valued. This important point cannot be overstated.

Determining the analysis subject is an important procedure in any tax-related transfer price analysis, and it is especially important when using the CUT method. This is because the credibility of the CUT method is based on identifying comparable transactions involving comparable property.

If, for example, the controlled transaction in a CUT method analysis included the transfer of a bundle of marketing-related intangible property, including trademarks, brand names, contracts, methods, customer lists, and technical data, then any selected CUT should include a similar property bundle.

For purposes of the Section 482 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."[11]

In other words, the Section 482 regulations allow for inexact comparable transactions to be used to estimate an arm's-length result, if adjustments are made to increase the degree of comparability with the controlled transaction.

Other Considerations in the Analysis of Trademark Royalty Rates

There are numerous attributes to consider in the trademark royalty rate analysis. These attributes may be either quantitative or qualitative in nature. Table 1 presents a list of some of the economic attributes that analysts typically consider in a trademark royalty rate analysis.[12]

Table 1
Attributes That Affect the Pricing of Trademark Royalty Rates

Item	Economic Attribute	Positive Influence on Pricing Analysis	Negative Influence on Pricing Analysis
1	Age-absolute	Long established trademark	Newly created trademark
2	Age-relative	Older than competing trademarks	Newer than competing trademarks
3	Use-consistency	Subject trademark used consistently on related products and services	Subject trademark used inconsistently on unrelated products and services
4	Use-specificity	Subject trademark is general and can be used on a broad range of products and services	Subject trademark is specific and can only be used on a narrow range of products and services
5	Use-geography	Subject trademark has wide appeal (e.g., can be used internationally)	Subject trademark has narrow appeal (e.g., can only be used locally)
6	Potential for expansion	Unrestricted ability to use subject trademark on new or different products and services	Restricted ability to use subject trademark on new or different products and services
7	Potential for exploitation	Unrestricted ability to license subject trademark into new industries and uses	Restricted ability to license subject trademark into new industries and uses
8	Associations	Subject trademark associated with positive person, event, location	Subject trademark associated with negative person, event, location
9	Connotations	Subject trademark has positive connotations and reputation among consumers	Subject trademark has negative connotations and reputation among consumers
10	Timeliness	Subject trademark is perceived as modern	Subject trademark is perceived as old-fashioned
11	Quality	Subject trademark is perceived as superior	Subject trademark is perceived as less superior
12	Profitability, absolute	Profit margins or investment returns on products and services higher than industry average	Profit margins or investment returns on products and services lower than industry average
13	Profitability, relative	Profit margins or investment returns on products and services higher than competing subject trademarks	Profit margins or investment returns on products and services lower than competing subject trademarks
14	Expense of promoting	Low cost of advertising, promotion, deals, or other marketing of subject trademark	High cost of advertising, promotion, deals, or other marketing of subject trademark
15	Means of promoting	Numerous means available to promote subject trademark	Few means available to promote subject trademark
16	Market share, absolute	Trademarked products and services have high market share	Trademarked products and services have low market share
17	Market share, relative	Trademarked products and services have higher market share than competing names	Trademarked products and services have lower market share than competing names
18	Market potential, absolute	Trademarked products and services are in an expanding market	Trademarked products and services are in a contracting market
19	Market potential, relative	Market for trademarked products and services expanding faster than competing trademarks	Market for trademarked products and services expanding slower than competing trademarks
20	Trademark recognition	Subject trademark has high recognition (e.g., high aided or unaided recall among consumers)	Subject trademark has low recognition (e.g., low aided or unaided recall among consumers)

Some of the economic attributes may be more relevant to one trademark than another. However, these attributes can help the analyst perform an overall assessment of the quality and nature of the subject trademarks before conducting a pricing analysis. This assessment assists the analyst in:

1. understanding the use and function of the subject trademarks and
2. identifying the factors (and, ultimately, the methods and procedures) that are important in the pricing of the subject trademarks.

Sources of Trademark License Agreements

Analysts rely on a number of data sources in order to identify comparable trademark license agreements. These data sources include government databases, news and industry trade publications, and third-party subscription-based royalty rate databases.

Examples of third-party intangible property license agreement royalty rate databases include the following:

1. Business Valuation Resources ktMINE Database
2. Royalty Connection Database
3. RoyaltySource Intellectual Property Database
4. Royalty Range European Royalty Database

These third-party royalty rate data providers collect transactional data involving intangible property (including trademark) license agreements from publicly available sources, such as SEC filings, news articles, industry trade publications, and company press releases.

Analysts can search these royalty rate databases to identify license agreements that have factors comparable to the factors of the subject intangible property.

The transactional data contained in these third-party royalty rate databases can provide analysts with the fact-based evidence required to estimate an arm's-length trademark royalty rate.

Selecting Comparable Transactions

When selecting comparable trademark license transactions for a transfer pricing analysis, all of the relevant factors that affect the price that would be paid or the profit that would be earned in the transactions should be considered.

The Section 482 regulations indicate that in order for the intangible property involved in an uncontrolled transaction to be considered comparable to the intangible property involved in the controlled transaction, both intangible properties should be used (1) in connection with similar products or processes and (2) in the same general industry or market. In addition, both intangible properties should have similar profit potential.[13]

Analysts should focus on these three comparability factors when reviewing and selecting comparable trademark license transactions.

Other factors that may be relevant in assessing the comparability between the controlled and uncontrolled transactions include the following:

1. The terms of the transfer (including exclusivity characteristics, limitations on use, or geographical area in which the rights may be exploited)
2. The stage of development of the intangible property
3. The rights to receive updates, revisions, or modifications of the intangible property
4. The uniqueness of the intangible property
5. The duration of the license and any termination or renegotiations rights
6. The economic and product liability risks to be assumed by the transferee
7. The existence of any collateral transactions or ongoing business relationships between the transferee and the transferor
8. The functions to be performed by the transferor and the transferee[14]

To select defensible comparable trademark royalty rates, analysts should prepare a thorough and well documented comparability analysis of the controlled and uncontrolled transactions based on the above listed comparability factors.

This procedure will ensure that the functions and risks related to the comparable uncontrolled transactions are similar to the subject controlled transactions. And, this procedure will demonstrate that the analyst considered the nature of the transactions, as well as the factors and circumstances that affect the price that would be paid or the profit that would be earned in the transactions.

Establishing the Royalty Range

The Section 482 regulations allow that an arm's-length result could fall within a range. That is, if the taxpayer operating results fall within the arm's-length price range, which is derived from applying the same pricing method to two or more uncontrolled transactions that have a similar level of comparability and reliability, then no adjustment will be made to the taxpayer income or deductions.

What this indicates, in the context of this discussion, is that if the royalty rate charged by the taxpayer in the controlled transaction falls within the range of royalty rates derived from comparable uncontrolled transactions, then it will be considered to be an arm's-length price result.

The arm's-length price range consists of the results of all of the comparable uncontrolled transactions that meet the following conditions:

1. The information on the controlled transaction and the comparable uncontrolled transactions is sufficiently complete that it is likely that all material differences have been identified.
2. Each such difference has a definite and reasonably ascertainable effect on price or profit.
3. An adjustment is made to eliminate the effect of each such difference.

If there are no comparable uncontrolled transactions that meet these conditions, then the arm's-length range is derived from the results of all the comparable uncontrolled transaction that achieve a similar level of comparability and reliability. In such cases, the reliability of the analysis should be increased, where it is possible to do so. This objective is accomplished by adjusting the indicated range through the application of a valid statistical method.

The interquartile range ordinarily provides an acceptable measure of this range. The interquartile range is the range from the 25th percentile to the 75th percentile of the results derived from the comparable uncontrolled transactions.

Conclusion

Trademarks, trade names, and brand names are valuable assets that are frequently transferred (or licensed) between related parties. Analysts are often tasked with estimating an arm's-length royalty rate as part of a tax-related transfer pricing analysis.

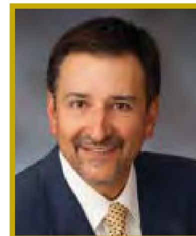
". . . if the taxpayer operating results fall within the arm's-length price range, . . . then no adjustment will be made to the taxpayer income or deductions."

Trademark royalty rates are typically one of the contested aspects involved in a transfer pricing dispute. In order to establish credible and defensible trademark transfer price royalty rates, analysts should:

1. follow the guidance provide in the Section 482 regulations,
2. confirm that the functions and risks related to the comparable uncontrolled transactions are similar to the subject controlled transaction, and
3. develop a comparability analysis that clearly documents the relevant factors and circumstances that affect the pricing of the subject trademark royalty rate.

Notes:

1. Treas. Reg. §1.482-1(a)(1).
2. Treas. Reg. §1.482-1(b)(1).
3. Ibid.
4. Treas. Reg. §1.482-1(i)(4).
5. Treas. Reg. §1.482-4(a).
6. Ibid.
7. Treas. Reg. §1.482-4(d)(1).
8. Treas. Reg. §1.482-4(c)(2)(iii)(B)(i)-(ii).
9. Treas. Reg. §1.482-1(c)(1).
10. Treas. Reg. §1.482-4(b)(1) through (6).
11. Treas. Reg. § 1.482–1(d)(2).
12. Robert F. Reilly and Robert P. Schweihs, *Guide to Property Tax Valuation* (Chicago: Willamette Management Associates Partners, 2008), 359.
13. Treas. Reg. §1.482-4(c)(2)(iii)(B)(i)-(ii).
14. Treas. Reg. §1.482-4(c)(2)(iii)(B)(1)-(2)(i)-(viii).



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Structuring the Intangible Property Forensic Analysis Assignment

Robert F. Reilly, CPA

Valuation analysts are often called on to perform damages, valuation, royalty rate, arm's-length transfer price, remaining useful life, and various other forensic analyses related to commercial intangible property. There are 10 common elements, or stages, involved in most intangible property forensic analyses. This discussion summarizes these 10 intangible property forensic analysis assignment elements.

Introduction

This discussion summarizes the 10 typical stages of any intangible property (for purposes of this discussion, also called intangible asset) forensic analysis assignment.

For purposes of this discussion, such an intangible property forensic analysis may include a valuation, a damages analysis, an intercompany transfer price study, an intellectual property exchange ratio analysis, a sale or license transaction fairness opinion analysis, or any other related economic analysis.

The analyst will typically consider these 10 stages, or elements, before, during, and after performing any quantitative or qualitative intangible property analyses.

Analysts typically perform these procedures because consideration of these engagement elements typically make:

1. the subject forensic analysis more efficient and
2. the selected analytical procedures more effective.

And, analysts typically perform these procedures because the consideration of these engagement elements typically make the forensic analysis conclusion more credible, replicable, and supportable.

Each of these 10 intangible property analysis engagement elements is summarized in the following discussion.

Understand the Forensic Analysis Purpose and Objective

A clear and concise statement of understanding of the purpose and objective of the forensic analysis will help the analyst throughout the engagement. Such an understanding will help the analyst plan and execute the analysis. And, such an understanding will help keep the analyst on track throughout the various stages of the forensic analysis.

The first component of the purpose and objective of any intangible property forensic analysis is a complete description of the subject intangible property. Before quantifying any valuation, damages, transfer price, or other conclusion, the analyst should understand what intangible property is included in the forensic analysis.

A written description of the subject intangible property should allow a report reader (or any other interested party) to better understand the scope of the intangible property encompassed in the subject forensic analysis.

With regard to a complex owner/operator, a complex litigation, or a complex transaction, such a written description will also help the report reader (or other interested party) to understand what properties (tangible or intangible) are not included in the subject forensic analysis.

The second component of the purpose and objective is a description of the intangible property

subject property rights. An inexperienced analyst may naively assume that the subject bundle of rights is a fee simple interest. That assumption may coincidentally prove to be correct.

However, many intangible property valuation, damages, or transfer price analyses involve consideration of either a fractional ownership interest or a limited term interest. Differences in the subject bundle of legal rights can materially affect the intangible property analysis conclusion.

The third component of the purpose and objective is a definitive statement of analysis objective. Unfortunately, owner/operators, legal counsel, and others are often imprecise when they describe the intangible asset assignment to the analyst.

Such client parties often call the engagement a valuation when the defined value of the intangible property is not the analysis objective.

Before the engagement begins, the analyst, the client, counsel, and any other interested parties should understand if the forensic analysis objective is to conclude a defined value, a fairness opinion, a solvency opinion, an exchange ratio (or a reasonably equivalent value), a royalty rate, a license fee, a damages measure, a transfer price, or some other conclusion.

The fourth component of the purpose and objective relates primarily to a valuation assignment. That is, if the engagement objective is to conclude an intangible property value, what is the appropriate standard of value? The term "standard of value" is typically considered to be synonymous with the term "definition of value."

And, for the most part, the standard of value answers the question: value to whom? Before the valuation engagement begins, all parties should agree whether the intended standard of value is fair value, fair market value, owner value, use value, investment value, acquisition value, reasonably equivalent value, arm's-length price, or some other standard of value.

The fifth component of the purpose and objective is the forensic analysis "as of" date. Typically, the client or legal counsel will inform the analyst of the appropriate as of date. That date will often relate to a specific transaction, fraudulent transfer, breach of contract, tort-related damages event, regulatory filing, or other reason to conduct the forensic analysis. It is often helpful for the analyst to understand the significance of the selected as of date.

The analysis date can be either historical (often called retrospective), contemporaneous (often called current), or prospective (that is, in the future). The analyst should also know if the forensic analysis involves a series of analysis dates, such as:

1. a license agreement start date and stop date or
2. a damages period first event date and a damages termination date.

The sixth component of the purpose and objective is a clear statement of the purpose of the forensic analysis. The purpose of the analysis explains why the analysis was prepared. The purpose may also state (or at least indicate) who may rely on the results of the analysis.

While there are numerous individual reasons to prepare an intangible property analysis, most of these individual reasons may be grouped in the following categories of purposes:

1. Notational—for example, for financial accounting, regulatory compliance, or management information purposes
2. Transactional—for example, for sale, license, transfer, financing, or similar reasons involving an actual exchange of the subject asset or of cash
3. Litigation—for example, a measurement of value or damages to convince a finder of fact in a contemplated or actual litigation
4. Taxation—for example, for income tax, gift or estate or generation-skipping transfer tax, or ad valorem property tax planning or compliance
5. Other—for example, any other purpose that does not fit one of the above-mentioned categories

Consider the Intangible Property Highest and Best Use

The analyst's consideration and conclusion of highest and best use (HABU) affects each type of intangible property analysis. HABU considerations affect intangible property value, damages, transfer price, and other forensic analysis conclusions.

This is because the HABU conclusion affects whether the subject analysis considers the intangible property as part of the following transactional scenarios:

1. As a stand-alone, individual asset
2. As part of an assemblage with other, related intangible assets
3. As part of a going-concern business enterprise.

Often, the client or legal counsel instructs the analyst as to the appropriate HABU assumption, often called the appropriate premise of value. However, without such an instruction, the analyst may have to select the premise of value that concludes the intangible property HABU.

The criteria that the analyst typically uses to assess an intangible property HABU are the same as the criteria that an appraiser typically uses to assess a tangible property HABU.

The four typical criteria for HABU are as follows:

1. Legal permissibility—the selected transactional premise must be legal.
2. Physically possible—the selected transactional premise must be physically possible.
3. Financially feasible—the selected transactional premise must provide a fair rate of return to the owner/operator.
4. Maximally productive—the selected transactional premise must result in a higher value than the remaining alternative premises that meet the first three criteria.

Document the Above-Listed Elements in an Engagement Letter

The analyst can be an independent contractor working for a third-party owner/operator. Or, the analyst can be an employee working for an employer owner/operator.

In either case, it is a best practice for the analyst to document each of the above-described elements of the analysis in some form of written documentation.

Typically, the independent analyst will prepare a written engagement letter for the client or legal counsel. Typically, the employee analyst will prepare a written assignment memorandum for the supervisor or for the assignment file.

In both cases, the analyst will describe the intangible asset assignment purpose and objective. Such documentation is a best practice because it helps ensure that the analyst and the client (or the employer) have a consistent understanding of the assignment.

Such documentation alleviates the potential for misunderstanding between the parties. And, such documentation serves as a guideline for the analyst throughout the assignment. That is, the analyst can refer to the engagement letter (or memo) to ensure that the analyst is actually performing the analysis he or she set out to prepare.

The engagement letter will typically document important assignment due dates. Such due dates may include the following:

1. When the client (or counsel) needs the quantitative analysis results
2. When the client (or counsel) needs a written analysis report
3. The expected date of trial testimony, a board presentation, a regulatory hearing, or other presentation event
4. Dates of any other deliverables, such as audit assistance, negotiation between contract counterparties, litigation support, or any other post-report activities

The engagement letter should document not only the date of any other deliverables, but also the scope of any other deliverables.

That is, the letter (or memo) typically documents any continuing analyst commitment to periodically update the analysis, appear before taxation or other regulatory authorities, be named as a valuation expert in a Securities and Exchange Commission filing or other public document, be named as a testifying expert in litigation, and so forth.

Determine the Appropriate Type of Report

The instruction as to the appropriate report form and format will typically come from the client or legal counsel. The analyst should be aware of the type of report that the client needs.

The analyst should also generally be aware of why the client needs the specified type of report (e.g., for tax compliance, regulatory compliance, litigation, or other purposes).

The analyst should understand the required report type from the inception of the engagement. That way, as each analysis is performed, the analyst can consider how that analysis can be described in the final report.

There are several forms and formats of reports that may be appropriate to the intangible property analysis. The following report type descriptions are intentionally general.

That is, the following report titles do not comply with the Uniform Standards of Professional Appraisal Practice (USPAP), the American Institute of Certified Public Accountants (AICPA) Statement on Standards for Valuation Services (SSVS), or any other specific organizational standard that the analyst may intend to comply with. That is because the

aforementioned professional standards only apply to valuation engagements.

In contrast, the following general report format descriptions are generally applicable to many types of intangible property analyses.

1. Memo report—Often, a client or employer only needs a memorandum that states the analysis assignment, methodology, research analyses, and conclusions; such a memo report may or may not include schedules or exhibits that summarize the related quantitative analyses.
2. Opinion report—Many types of reports have a typical format that is generally accepted by practitioners within the professional community; some examples of such opinions include fairness (for a sale or license transaction) opinions, solvency opinions, and others.
3. Summary report—This type of report typically summarizes the analysis assignment, methodology, analyses, and conclusion; this type of report may not include all of the analyst's supporting work and all of the data sources relied upon. This type of report, however, typically includes sufficient schedules and exhibits to allow the report reader to replicate the subject analyses and confirm the subject conclusion.
4. Narrative report—This type of report format typically describes the analysis assignment, methodology, analyses, and conclusions sufficiently to allow the reader to recreate the analyst's thought process; this report type typically includes virtually all of the analyst's supporting work and the data sources relied upon. It typically includes detailed schedules and exhibits to allow the report reader to replicate all of the quantitative and qualitative analyses and to recreate the subject conclusion.
5. Oral presentation—Much like a written memo report, often the client or employer only needs a summarized presentation of the analyst's work and conclusion; the oral presentation may be accompanied by a presentation flip chart that includes an outline of the points made by the analyst during the oral presentation. Such a presentation is common when the analyst is advising the owner/operator or other parties with regard to management decision-making; such an oral report format is usually not applicable in a contrarian (e.g., litigation) environment.
6. Oral testimony—This type of oral report is usually presented in a contrarian environment where the analyst may be testifying under oath or at least is subject to some form of contrarian review; in such an oral report, the analyst may completely describe all elements of the analysis assignment, methodology, analyses, and conclusion. The oral testimony may also be accompanied by either a summary written report or a narrative written report.

Intangible property analysts should be aware that the expert report prepared for litigation purposes may have to comply with specific reporting standards. The analyst should confer with legal counsel regarding the appropriate report form and format for the subject jurisdiction.

For example, in a matter litigated in a federal court, the analyst's report may have to comply with the Federal Rules of Evidence Rule 26 regarding the admissibility of expert reports. Again, the analyst should obtain legal instruction from counsel with regard to the form and format of such an expert report.

Consider Applicable Professional Standards

The analyst should consider if there are any professional standards that apply to the development of the analysis, the reporting of the analysis results, or both.

The extent to which certain professional standards apply to the subject analysis is a function of both:

1. the type of intangible asset analysis and
2. the type of intangible asset analyst.

For example, different standards may apply to a valuation engagement, economic damages engagement, transfer price study, or other type of intangible property analysis. And, different standards may apply, for example, to a certified public accountant (CPA) compared to a non-CPA performing the same analysis.

CPAs who perform intangible property valuations will comply with the AICPA Statement on Standards for Valuation Services (SSVS). CPAs who perform intangible property damages analyses will comply with the AICPA Statement on Standards for Consulting Services (SSCS). And, CPAs who perform intangible property transfer price analyses

for income tax purposes will comply with the AICPA Statement on Standards for Tax Services (SSTS).

Members of various other professional organizations also perform intangible property valuation services. Such analysts will comply with the professional standards promulgated by the organizations of which they are members.

For example, the American Society of Appraisers (ASA), the Institute of Business Appraisers (IBA), and the National Association of Certified Valuators and Analysts (NACVA) all have professional standards that may apply to intangible property valuations.

The Uniform Standards of Professional Appraisal Practice (USPAP) contains standards rules that relate to intangible property appraisals. Certain intangible property appraisers will comply with USPAP when such compliance is required by either:

1. law,
2. regulation, or
3. an agreement with the appraiser's client.

Nonetheless, there are no all-embracing professional standards with which all analysts should comply with regard to intangible property valuations. For example, economists, academics, industry analysts, licensing executives, or financial planners who perform intangible property valuations do not need to comply with any of the above-mentioned professional standards.

The same statement is true with respect to intangible property damages analyses. Other than AICPA standards and technical practice aids that apply to CPAs, there are no other economic damages professional standards that apply to non-CPA analysts.

Likewise, there are no promulgated professional standards for other intangible property analyses such as exchange ratio measures, license royalty rate studies, remaining useful life and amortization studies, etc.

All analysts who perform intercompany transfer price studies for federal income tax purposes will comply with the procedural guidelines listed in the Treasury Regulations related to Internal Revenue Code Section 482. However, there are also no professional standards related to intangible property transfer price analyses.

The above discussion relates specifically to promulgated professional standards. The lack of standards for certain types of analyses and for certain types of analysts should not imply that there are not best practices related to all intangible property analyses.

These best practices are incorporated in generally accepted professional practices and procedures. However, these best practices may not be documented in written professional standards. Nonetheless, any analyst should be prepared to justify a departure from the generally accepted professional practices with respect to any individual intangible property analysis.

As mentioned above, there are evidentiary requirements related to any intangible property analysis performed for litigation purposes. Such requirements involve whether the judicial finder of fact will accept the analyst's expert report and expert testimony as evidence in the particular proceeding.

These rules of evidence vary between the various federal courts, between federal and state courts, and between the various state courts.

Intangible property analysts should obtain legal instructions from the client's counsel regarding:

1. the applicable rules of evidence and
2. the analyst's compliance with the applicable rules of evidence.

Assemble and Supervise Appropriately Trained Staff

Unless the subject analysis is particularly simple, it is not uncommon for a supervisory analyst to assemble and work with a team of intangible property analysts.

In such instances, the supervisory analyst is usually the individual:

1. who has overall responsibility for the engagement;
2. who will reach the final value, damages, transfer price, etc. conclusion; and
3. who will sign the analysis written report and/or deliver the analysis oral report.

In such cases, the supervisory analyst should ensure that all members of the engagement team:

1. have adequate experience and expertise to work on the analysis,
2. are adequately trained and supervised throughout the engagement,
3. have a sufficient understanding of the elements of the assignment,
4. have a sufficient understanding of the assignment time and fee budget,
5. have a sufficient understanding of the assignment deliverables, and

6. have a sufficient understanding of the analysis documentation requirements.

Of course, the supervisory analyst should ensure that each team member understands his or her role in the preparation of the analysis development and of the forensic analysis report.

Collect and Confirm Sufficient Data to Perform the Analysis

Whether or not the analyst has a team of assistants, the analyst is ultimately responsible for the adequacy of the data collection and due diligence procedures.

In most types of intangible property forensic analyses, the analyst may collect and synthesize five categories of data:

1. Owner/operator documents—including a description of the owner/operator, a description of the use of the intangible property, historical financial statements, and prospective financial statements
2. Intangible property data—including information about the intangible property age, original development efforts and costs, maintenance activities, current use in the owner/operator business operations, and expected future use in the owner/operator business operations
3. Subject transaction documents—including documents related to an ownership, transfer, license, financing, pending litigation, or any other event that is the subject of the intangible property analysis
4. Industry data—including information about the industry that the owner/operator competes in and about any industry that can (or does) use the subject intangible property
5. Comparable transaction data—including data regarding comparable companies to the owner/operator, sales of comparable intangible property, and licenses of comparable intangible property

Select and Perform the Appropriate Analysis Methodology

The experienced analyst is aware that there are generally accepted methods and procedures related to each type of intangible property forensic analysis. That is, there are generally accepted methods and procedures related to intangible property valuations, economic damages measures, intercompany transfer price studies, and other analyses.

In each particular analysis, the analyst will apply the most appropriate methods based on the following criteria:

1. The quantity and quality of available data
2. The purpose and objective of the analysis
3. The specific factors related to the subject intangible property
4. The specific factors related to the subject intangible property transaction
5. The analyst's perception of the methods used by actual market participants

Ultimately, the analyst will rely on his or her reasoned judgment and professional experience in the selection of the appropriate analysis methods. Relying on that judgment and experience, the analyst should be prepared to explain the reasoning for:

1. accepting the analysis methods that were used and
2. rejecting the analysis methods that were not used.

In addition, the analyst should be prepared to explain any departures from the generally accepted methods and procedures that are applicable to the subject intangible property analysis.

In particular, the analyst should expect to explain any such departures in an intangible property analysis prepared for litigation purposes.

Reach a Replicable and Well-Supported Analysis Conclusion

The synthesis and conclusion of any intangible property forensic analysis is ultimately the responsibility of the principal analyst. Like the selection and application of the analysis methods, reaching the final analysis conclusion is ultimately a matter of the analyst's judgment and experience.

In reaching a final analysis conclusion, the analyst will consider if there are any applicable regulatory considerations. For example, the conclusion of an intangible asset royalty rate is usually based on a synthesis of the results of several royalty rate estimation methods.

“. . . the analyst’s objective is to make the forensic analysis conclusion as replicable and as transparent as possible.”

However, the conclusion of an intangible asset intercompany transfer price is typically based on the result of a single analysis method.

This is because the regulations related to Section 482 require the analyst to apply the so-called “best method rule.” That is, the analyst will select and apply the most appropriate of the allowable transfer price methods. And, then the final transfer price conclusion is based on the application of that single best method.

Typically, the analyst considers all indications from all methods in synthesizing the final analysis conclusion. The analyst typically reconciles all of the analysis indications in order to reach a weighted average overall conclusion.

Some analysts prefer to use a qualitative weighted average procedure, assigning a specific weighting percentage to (say) the method A conclusion versus the method B conclusion versus the method C conclusion.

Other analysts prefer to assign a more qualitative weighting to the various analysis indications. For example, without specifying percentages, the analyst may apply (say) the most weight to the method A conclusion, less weight to the method B conclusion, and the least weight to the method C conclusion.

Regardless of the reconciliation procedure used, the analyst’s objective is to make the forensic analysis conclusion as replicable and as transparent as possible. That way, another analyst can duplicate (and verify) the analyst’s reasoning and conclusion.

Also, a replicable, transparent conclusion is usually more convincing to the analyst’s client, the legal counsel, the finder of fact, or any other interested party.

Prepare a Well-Documented and Well-Reasoned Analysis Report

In preparing a report (written or oral) that is meaningful to the client, to counsel, and to other interested parties, the analyst considers if the report complies with the assignment requirements.

In particular, the analyst considers if the analysis and the report achieve both the purpose and objective of the assignment. In particular, the analyst will consider if the report complies with:

1. any applicable professional standards (including any litigation-related requirements)
2. the terms and conditions of the engagement letter or engagement memo
3. the informational needs of the client (or any other interested parties)

For intangible property analyses prepared for litigation or related purposes, the analyst considers if the report work product complies with all applicable litigation, taxation, regulatory, or other requirements. If the analyst is not absolutely sure of the appropriate requirements, then he or she should consult with the legal counsel.

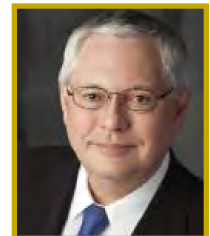
Summary and Conclusion

There are normally 10 stages to most intangible property forensic analyses. These 10 stages are typically applicable to an intangible property valuation, damages analyses, transfer price study, or other type of analysis.

In performing the intangible property forensic analysis, the analyst will:

1. understand the assignment purpose and objective,
2. conclude the intangible asset HABU,
3. document the assignment elements in an engagement letter or memo,
4. consider the appropriate report form and format,
5. apply any applicable professional standards,
6. train and supervise the engagement team,
7. collect and confirm sufficient data,
8. select and perform the appropriate methodology,
9. reach a well-supported analysis conclusion, and
10. prepare a well-documented analysis report.

The effective structuring of the intangible property analysis assignment should result in (1) the efficient development of the forensic analysis and (2) the clear reporting of a well-supported analysis conclusion.



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On Our Web Site

Recent Articles and Presentations

Frank "Chip" Brown, director of our Atlanta office, participated in a panel discussion webinar on "It's a New World for ESOPs: The DOL/Great Banc Fiduciary Process Agreement and Recent Court Decisions." The webinar presentation was delivered on October 28, 2014, It was sponsored and produced by the American Bar Association Joint Committee on Employee Benefits. Chip's co-presenters were Robert Rachal (moderator) of Proskauer Rose, Theodore Becker of Drinker Biddle, Jeffrey Hahn from the U.S. Department of Labor, and Karen Handorf of Cohen Milstein.

This presentation provided a brief history of ERISA. It explored the topic of valuation in employee stock ownership plan (ESOP) cases. The presentation discussed the criteria for selecting an ESOP adviser. It also explored various methods and approaches for the valuation of ESOP-owned stock. Finally, several recent court cases were discussed.

Robert F. Reilly, a managing director of our firm, authored an article that was published in the October/November issue of Financial Valuation and Litigation Expert, a bi-monthly journal published by Valuation Products and Services. The title of Robert's article is "Qualitative Considerations in the Intellectual Property Valuation."

Robert's article examines the various reasons to value intellectual property. He discusses the attributes of intellectual property. Robert then explores the factors that influence the value of intellectual property.

Robert Reilly delivered a presentation on October 21, 2014, at the National Association of Property Tax Representatives—Transportation Energy Communications Conference in Dallas, Texas. The title of Robert's presentation was "Intangible Asset Valuation: Cost Approach Valuation Methods and Procedures."

Robert's presentation explored the topic of what is what is not an intangible asset. He discussed various reasons for valuing intangible assets. Robert focused his discussion on the cost approach to intangible asset valuation. He then explored various methods and procedures within the cost approach and presented an example of a cost approach analysis of a trained and assembled workforce asset.

Robert Reilly delivered a presentation on October 14, 2014, at the Texas Society of CPAs Business Valuation, Forensic & Litigation Services Conference in Fort Worth, Texas.

Robert's presentation explored the topic of what is and what is not an intangible asset. He discussed various types of intangible asset analyses. Robert discussed various approaches and methods for valuing intangible assets. He also discussed common methods of measuring damages in intangible asset infringement cases. Finally, Robert discussed things to consider in the preparation of an intangible asset valuation or damages report.

The slides from these presentations and webinars, along with other presentation materials and selected published articles, are available on our website.

www.willamette.com

Communiqué

In Print

Robert Reilly, firm managing director, authored an article that appeared in the October/November 2014 issue of the journal *Financial Valuation and Litigation Expert*. The title of Robert's article was "Qualitative Considerations in the Intellectual Property Valuation." Robert is also a member of the editorial advisory board of that professional valuation journal.

Robert Reilly also authored an article in the October 2014 issue of *Business Valuation Alert*. The title of Robert's article was "Intangible Asset Cost Approach Illustrative Example, Part II." Part I of this article appeared in the July 2014 issue of that journal.

Robert Reilly also had a second article published in the October 2014 issue of *Business Valuation Alert*. The title of that article was "Valuation of the Licenses and Permits Intangible Asset."

Robert Reilly authored Chapter 1 in the Business Valuation Resources valuation textbook published in 2014 called *Business Valuation & Bankruptcy: Case Law Compendium*. The title of Robert's chapter is "Ten Current—and Controversial—Issues in Bankruptcy Valuations."

Robert Reilly also authored an article that appeared in the November/December 2014 issue of *Today's CPA*, the journal of the Texas Society of Certified Public Accountants. The title of Robert's article was "Reasons to Conduct an Intangible Asset Valuation."

Robert Reilly also authored an article in the Fall 2014 issue of the *American Journal of Family Law*. The title of Robert's article was "Family Law Valuation of Customer Intangible Assets."

Robert Reilly also authored an article in the July 2014 issue of *FVS Consulting Digest*, a journal of the American Institute of Certified Public Accountants. This article was the second part of a two-part series of articles titled "Valuation of the Customer Intangible Asset." Part one of this two-part series appeared in the April 2014 issue.

Robert Reilly also authored an article in the July/August 2014 issue of *Construction Accounting and Taxation*. The title of Robert's article was "Attributes That Influence Intellectual Property." Robert also serves as the valuation editor of that professional journal.

Robert Reilly also authored an article that appeared in the September 2014 issue of the *ABI Journal*. The title of Robert's article was "The Valuation of Contract-Related Intangible Assets." Robert also serves as the valuation editor of this journal of the American Bankruptcy Institute.

Kevin Zanni, manager in the Chicago office, authored an article that appeared in the July/August 2014 issue of *The Value Examiner*, the journal of the National Association of Certified Valuators and Analysts. The title of Kevin's article was "Private Company Discount Studies and Application to Non-Marketable Interests."

Justin Nielsen, manager in the Portland office, authored an article that appeared in the National Association of Certified Valuators and Analysts e-newsletter, quickreadbuzz.com, on September 17, 2014. The title of Justin's article was "Considering the Subject Industry in the Discounted Cash Flow."

In Person

Firm managing director Bob Schweihs delivered a presentation at the Institute for Professionals in Taxation webinar on December 4, 2014. The title of Bob's presentation was "Valuation of Identifiable Intangible Assets and Extraction of the Intangible Asset Value from the Total Property Value."

Chip Brown, a managing director in our Atlanta office, delivered a presentation at the American Bar Association Joint Committee on Employee Benefits webinar on October 28, 2014. The title of the webinar was "It's a New World for ESOPs: The DOL/Great Banc Fiduciary Process Agreement and Recent Court Decisions."

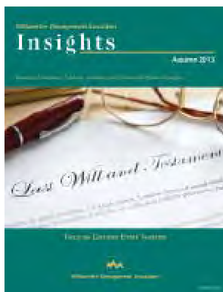
In Encomium

Curtis Kimball, an Atlanta office managing director, and his wife Marilyn Kimball, were the first recipients of the "Spotlight on Volunteers" award from the Atlanta Society of Finance and Investment Professionals (ASFIP). The Kimballs were selected for this honor because of the continuing years of volunteering they have performed with ASFIP local societies, and also with the Chartered Financial Analyst (CFA) Institute.

INSIGHTS ARCHIVES

❑ Autumn 2014

Focus on Gift, Estate, and Generation-Skipping Tax Issues

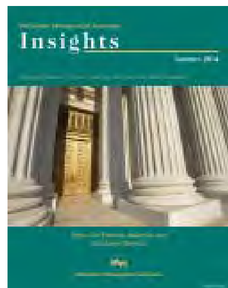


❑ Autumn 2013

Focus on Gift and Estate Taxation

❑ Autumn 2012

Focus on Intangible Asset Valuation



❑ Summer 2014

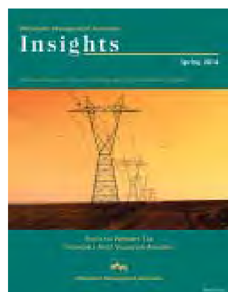
Focus on Forensic Analysis and Litigation Services

❑ Summer 2013

Focus on Transaction Advisory Services

❑ Summer 2012

Focus on Estate and Gift Tax Issues

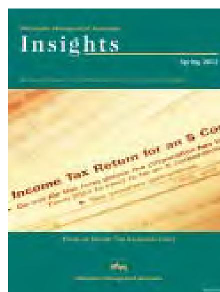


❑ Spring 2014

Focus on Property Tax Intangible Asset Valuation Analyses

❑ Spring 2013

Focus on Forensic Analysis and Litigation Services



❑ Spring 2012

Focus on Income Tax Valuation Issues

❑ Winter 2014

Focus on Bankruptcy and Reorganization Financial Advisory Services

❑ Winter 2013

Focus on Health Care Valuation Insights

❑ Winter 2012

Focus on Property Tax Valuation Practices and Procedures

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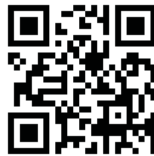

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