BATES WHITE
ECONOMIC CONSULTING 1300 Eye Street NW, Suite 600, Washington, DC 20005 main 202.408.6110 fax 202.408.7873

Patrick Breslin Comments on

The Discussion Draft on Chapter VI of
the OECD Transfer Pricing Guidelines[1]

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I would like to thank the OECD Committee on Fiscal Affairs and Working Party No. 6 for the opportunity to comment on this very important project. I also commend the OECD for the substantial work done to date and for providing a discussion draft far ahead of schedule, further enabling business persons and practitioners to participate in the exchange of views needed to produce the anticipated revisions of the OECD guidelines Chapter VI.

In addition to many years working as a transfer pricing economist, my experience as a business executive informs my perspective. As founder and CEO of a software company, I negotiated and implemented multiple software technology license agreements and other transactions involving intangibles, including in joint venture contexts. I also hired and managed highly skilled teams of software engineers and marketing professionals, managed an intellectual property (IP) portfolio, and negotiated financial arrangements with strategic investors. These experiences provide insights on subjects relevant to Chapter VI.

While open areas remain, the draft successfully addresses many complex issues regarding intangibles in a clear, concise and comprehensive manner. Many of my comments are supportive of or elaborate on certain aspects of the existing draft, while others provide suggestions on items going forward.

Given the many interactions between issues related to intangibles, these comments often refer to sections A through D of the draft in alternative order, in order to facilitate discussion of interrelationships between various issues. The comments also highlight themes that are well-covered in the Discussion Draft, but may also benefit from some related commentary. These themes include:

1. The need to **avoid "contextual mismatches"** in arm's length analysis, such as when applying valuation techniques and comparing arm's length evidence to controlled transactions,
2. The need to analyse **competitive conditions** that exist between uncontrolled parties to transactions involving intangibles and how they can significantly affect an analysis of controlled transactions,

[1] *Discussion Draft: Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions*, 6 June to 14 September 2012. Hereafter, the terms "Discussion Draft" or "the draft" will refer to this publication, released on June 6, 2012 by Working Party No. 6 of the OECD Committee on Fiscal Affairs.

3. The need to account for the fact that **interrelated intangibles** are often transferred collectively when using these transfers to define an arm's length standard for controlled transactions, and
4. The need to identify **valuable contributions** and ownership attributes that entitle parties to significant returns from intangibles.

Additionally, my comments explore the potential overlap between valuation approaches traditionally applied in transfer pricing analysis and certain tools adapted from other situations, ranging from finance-related concepts to IP infringement damages contexts.

Avoiding Contextual Mismatches

Some transfer pricing analyses rely upon, rather than avoid, contextual mismatches in analyzing intangibles. Such mismatches occur when applying certain valuation approaches and related assumptions, and when analyzing the comparability of transactions and other arm's length evidence, facts and circumstances. Even when such differences are recognized, they are often insufficiently addressed through adjustments intended to overcome their effects on value. Examples of contextual mismatches provided in these comments include:

- Use of valuation approaches that are incompatible with arm's length analysis and intended for very different purposes (e.g. purchase price allocation),
- Valuing intangibles that are only used and transferred collectively (e.g. software and software updates) as if they were not interrelated, and
- Analyzing intangibles contributed for the purposes of ongoing development as if they would be allowed to become obsolete.

The draft provides many useful references that should help practitioners avoid such contextual mismatches or appropriately address them. For example, it often highlights the tension between separate valuation of individual intangibles (or groups of intangibles) *versus* an aggregate approach when they operate collectively with inherent interactions between them. As paragraph 7 notes,

> […W]hile some intangibles may be identified separately and transferred on a segregated basis, other intangibles may be transferred only in combination with other business assets. Therefore, separate transferability is not a necessary condition for an item to be characterized as an intangible for transfer pricing purposes.

Competitive Conditions: A common theme at arm's length

In uncontrolled contexts, valuable intangibles provide competitive advantages; thus, their owners vigorously protect them in order to preserve those advantages. Because of this, the terms of uncontrolled intangibles transactions often bring competitive concerns to the

forefront, as demonstrated by the limited scope of rights and restrictions provided in typical license agreements. A lack of focus on such competitive conditions has hindered arm's length analysis of intangibles transactions and has contributed to controversy.

Here, I use the term "competitive conditions" to specifically refer to those conditions that exist between two parties to a transaction, as opposed to more general market conditions, such as the level of competitiveness in a market. The draft sometimes highlights the latter, but should also emphasise that at arm's length, competitive conditions often directly affect the interactions between parties involved in an intangibles transaction and the terms under their agreements. Comparability analysis should take this into full consideration in such cases. In fact, "competitive conditions" represent a unifying theme for all of my comments and offer a useful lens through which to examine arm's length conditions related to intangibles transactions.

Identifying Intangibles

Section A.3: Comments on Categorisation of intangibles

Paragraph 13 under section A.3 ("Categorisation of Intangibles") properly concludes that, while it is "sometimes the case that various categories of intangibles are described and labels applied…the approach contained in this Chapter for determining arm's length prices in cases involving intangibles does not turn on these categorisations."

The core objective of arm's length analysis should be to determine arm's length *value*. That is, what would independent parties willingly agree to *pay* for the same or a similar transaction under comparable circumstances? This should be the overriding goal in arm's length analysis.

Often independent parties do not consistently *define* or categorise various underlying elements of intangibles transactions in the same way, much less share equal views on the separate values of items that operate and are transacted collectively. In such cases, there is no arm's length agreement on the separate, individual items, only one aggregate arm's length price.

However, when different parties hold rights in and incur risks and costs associated with different intangibles, an analysis must consider their attributes and relative value contributions. Such situations occur both at arm's length (such as joint development and marketing agreements between unrelated pharmaceutical companies) and between related parties. These issues are discussed later with respect to sections C and D.

It is also a welcome development that the draft limits its discussion on vague concepts such as "hard intangibles" and "soft intangibles" and leaves attempts to "delineate various classes or categories of intangibles" out of Chapter VI altogether. This should help focus discussion on arm's length valuation (i.e., what price independent parties would pay given the same or a similar transaction) and away from what to call each underlying item.

In contrast, a "definitional approach" that is often advocated can shift the focus away from arm's length value to a seemingly endless debate about various definitions of intangible (in fact, one dictionary definition of *intangible* states the meaning of the word as, "incapable of being realized or defined"[2]).

It is doubtful that any categorisation exercise would ever produce consensus and even less likely that actual business persons operating at arm's length would spend much time on it. Despite the lack of clear definitions or categorisations of intangibles in actual arm's length settings, business is conducted and transactions are concluded. Arm's length analysis should be conducted in the same vein.

Section A.4 Illustrations

Paragraphs 14-22 provide a useful representative list of commonly recognized intangibles. These illustrations give ample and proper context to Section A and later sections in the draft, which themselves add further illustrations. Nonetheless, here are a few comments:

Illustrating Competitive Conditions

Many references to competitive issues are already placed throughout the draft, such as with respect to certain 'market conditions' and 'comparability factors' (e.g. in paragraphs 8, 16, 25 and 26). However, as discussed above, competitive conditions that exist directly between parties to an uncontrolled transaction may have greater significance and merit further attention. Such conditions help to explain aspects of arm's length behaviour and transactions that may not otherwise come to light.

Competitive conditions include the critical role that valuable intangibles may play in creating and enhancing the competitive advantages of firms that develop and own them; *and* the fact that parties to uncontrolled transactions involving intangibles often are (or become) competitors by leveraging the same or similar intangibles.

While paragraphs 15 (*Patents*) and 16 (*Know-how and trade secrets*) each mention competitive issues, they do not emphasize the extent of the potential role that such issues play with respect to these types of intangibles. For example, a patented invention may provide the owner with "cost advantages" that are not available to its competitors (as stated in p. 15), but even more importantly, patents very often have much greater implications for competing firms and potential competition.

Indeed, the exclusive rights to an invention are sought primarily to *exclude* competition. Patents are granted as a matter of policy to reward inventors for their investment in potentially risky research with uncertain outcomes. Thus, they preclude others with greater or different resources (i.e., those with other competitive advantages) from using the invention

[2] As defined by *The Free Dictionary*, http://www.thefreedictionary.com/

to effectively compete with the inventor (or owner), without having invested in its development (or the development of competing technology).

Proprietary know-how and trade secrets also arise with competitive conditions in mind. This explains the confidentiality and secrecy surrounding them—which is just another avenue to keep competition at bay. Their close interactions with and contribution to the value of assembled workforces in place is usefully represented in paragraph 26 and elsewhere in the draft, as will be discussed further below.

As the draft notes, owners of intangibles place substantial restrictions and limitations on the rights of a licensee (or other party) to benefit from the intangibles beyond what is granted in the scope of legal agreements, such as licenses and other contracts (e.g., employment contracts).

Interrelated Intangibles: Which hand claps the loudest?

Paragraph 19, regarding brand intangibles, highlights another recurring theme with respect to the interrelationships that often occur between intangibles. As the paragraph notes, there is no consensus as to the uses of the terms "brand" *versus* "trademark" and "trade name," which are often used interchangeably. In other contexts, a "brand" may "represent a combination of intangibles including, among others, trademarks, trade names, customer relationships, reputational characteristics, and goodwill," and it may be "difficult or impossible to segregate or separately transfer the various intangibles contributing to brand value." This example also indirectly highlights the futility of a definitional approach to classifying intangibles.

Paragraph 68 (Section C) is another useful depiction of the complex interrelationships between intangibles that are used in combination. Here, a pharmaceutical product has three or more types of intangibles associated with it (i.e., patents, regulatory approval through testing and registration processes, and a trademark). Collectively, these intangibles are extremely valuable, but in isolation they each may have much less value. This indicates that they are interdependent in achieving the commercial success of the product—something very commonly seen with respect to intangibles at arm's length.

When one asks for the relative value contribution between two or more such intangibles, a challenging question is raised: "Which hand claps the loudest?" At arm's length, the answer to this question is often moot—for example, when only one of the transacting parties has developed and/or owns the rights in all relevant intangibles. For the end customer of such a product, weighing the relative values of the patent, the regulatory approval, and the trademark would be nonsensical. There is simply one arm's length price.

This also occurs in other arm's length dealings between unrelated companies. A typical software technology license will convey rights to use multiple intangibles, including software, related copyrights, proprietary systems and methods, patents, trademarks, etc. An

unrelated licensee is willing to pay one price (a royalty) that considers these all in combination and has no use for any of these as individual "parts."

In actual arm's length negotiations, unless it is necessary or otherwise helpful to identify and value individual intangibles in isolation, independent parties will not do so. It is complex to negotiate an agreed price on the entire transaction, and unnecessary parsing of details is avoided. The parties will simply compare their alternatives, usually by calculating their respective costs and benefits on a net present value basis, as addressed elsewhere in the draft.

However, multinational enterprises (MNEs) encounter such issues internally with greater frequency than in their arm's length dealings with other integrated companies. This is due to the necessary divisions of functions, assets and risks internally among their affiliates. Thus, transfer pricing analysis is often forced to grapple with such problems. Solutions will be discussed later, after examining problems with some approaches that often affect arm's length analysis of intangibles.

The Goodwill Paradox: Why purchase price allocation (PPA) is out of context

As noted in paragraph 21, goodwill is another term often used to refer to a number of different concepts. Among these are the "expectation of future trade from existing customers" and "reputational value." These items are difficult to disentangle from other intangibles discussed above, such as "customer relationships" and "trademarks," respectively. Indeed, as paragraph 19 accurately states, these and other intangibles are often cited collectively (along with "goodwill" itself) as potentially contributing to "brand intangibles." The draft considers goodwill, and all of these elements of goodwill, to be intangibles under the draft Chapter VI.

The draft raises questions about another form of goodwill derived from PPAs performed for accounting and tax purposes. In fact, paragraphs 22 and 110 properly dismiss any reliance on PPA analyses for transfer pricing purposes. On the whole, PPAs are incompatible with arm's length analysis of controlled transactions and, in fact, do not represent the actual valuation of uncontrolled transactions.

The first indication that a PPA is not contextually relevant for transfer pricing analysis is the fact that it must be done at all. That is, if the independent parties to the original transaction had agreed on values for separately identifiable intangible assets in arriving at the purchase price, there would be no need to conduct the PPA – the allocation would already exist.

As noted above, independent parties rarely need to separately identify and value individual intangibles and other assets when they are acquired collectively, and would not do so unnecessarily. The parties to the transaction may not share the same or equal views on the

definition and value of individual, underlying items. Nevertheless, at arm's length, business is conducted as usual.

In contrast, a PPA process occurs *after* an arm's length transaction, and thus it is neither part of the actual arm's length process, nor even a true valuation *per se*, but rather, an *ex post* allocation of a given arm's length transaction value. From there, it applies a series of hypothetical analyses in which intangibles and other assets that operate (and were recently transacted) collectively are valued as if they were not interrelated.

PPAs help create a common misperception that intangibles *must* be separately identified and valued in conducting an arm's length analysis of intangibles. Contextually, this may be done for accounting and financial reporting as well as domestic tax law purposes, but these are not contexts that reflect arm's length conditions.

As a result, reliance on a PPA in an arm's length analysis can introduce a range of unwanted effects, including the following:

- The PPA process uses an "item-by-item" valuation approach that will often depart dramatically from what independent parties would willingly agree and, in fact, *did* agree in the case of the actual transaction a PPA analyzes.

- Because the PPA process values 'separately identifiable intangible assets' as if they were not interrelated with the rest of the transaction as a whole, it often simultaneously undervalues such intangibles and creates a disproportionately large residual value that it then defines as "goodwill."

- PPA goodwill often equals well over half of the original market transaction value. Paradoxically, if most of this total value *does not* relate to separately identifiable assets, the reliability of the values that the PPA *does* attribute to separately identifiable intangibles becomes highly questionable.

- Often, PPA goodwill is said to relate to the "expectation of future trade from existing customers," while "customer relationships" are separately valued at a much lower percentage of the purchase price—without any explanation as to how one completely separates these two clearly interrelated concepts.

- Because PPA goodwill may be overstated, such value is likely related to various other intangibles, such as customer relationships, trademarks and other brand-related intangibles (i.e. in paragraph 19).

These effects arise largely because the PPA process attempts to value separately identifiable intangibles that were purchased collectively, while simultaneously being *unable* to identify the source of a very large portion of residual value—value then attributed to goodwill.

Transfer pricing analyses sometimes use or cite such valuation analyses with authority, even though they do not represent approaches that independent parties use or would agree to apply. However unlikely, even if unrelated parties had agreed on such separate individual values in arriving at a purchase price, the PPA would then either be redundant or depart from what the independent parties in fact agreed.

The notion that the PPA process can separately identify and account for less than half of the value of an actual arm's length purchase price is not a strong argument for considering such an asset-by-asset valuation approach for arm's length analysis. I refer to this conundrum as the "goodwill paradox."

The concerns with PPAs ultimately relate more broadly to misconceptions about the valuation of interrelated intangibles. Such issues have had a substantial effect on controversies involving intangibles transactions. An important example appears in *Veritas vs. Commissioner* in U.S. Tax Court. In that case, the Court rejected the Internal Revenue Service (IRS) expert's valuation analysis and his use of a present value of income method, in part because he valued the intercompany intangibles transaction "in the aggregate and he hasn't valued any of the intangibles separately." [3]

The IRS cited US regulations allowing for the aggregate valuation of interrelated items in a transaction, but did not convince the Court that doing so was common at arm's length. In fact, the taxpayer's own comparables aggregated multiple different intangibles and services in its licensing transactions with unrelated parties. However, the outcome in the case did not take this and related aspects of the arm's length evidence into account. As discussed elsewhere, separate valuation of intangibles is often out of context with transactions involving commercially successful intangibles.

Valuation examples in a proper context

Independent parties to a transaction usually compare the present values of income streams from their alternatives involving the same or similar assets and investments. This is true whether or not intangibles are defined and/or given separate consideration in other contexts. These arm's length conditions are depicted well in Example 19, where they are applied to hypothetical related parties that operate under such conditions.

In Example 19, a parent company (P) considers transferring intangibles to a related manufacturer (Company S) in a lower cost, lower tax country. Note that in this case, as would occur at arm's length, the starting point for the analysis involves P computing the present value attributed to its intangibles under the *status quo* (see Table 1, page 54). This could be considered a "before" scenario (or in some litigation contexts, a "but for" analysis, i.e. "but for" a subsequent event such as the proposed transfer of the intangibles). It is the baseline scenario upon which P considers its alternatives.

[3] Veritas Software Corp. v. Comr., 133 T.C. No. 14.

This baseline net present value ("NPV") is compared to the NPV of the alternatives faced by P. Similarly, Company S computes and compares its own alternatives on a NPV basis. These separate valuation processes done by each party form the bases upon which they negotiate (e.g., tables 2 and 3 in Example 19).

It is worth noting that the analysis in tables 1-3 does not separate or determine relative values for the different types of intangibles to be transferred (e.g., patents and trademarks). There is no need to separate them in this case because these intangibles operate collectively, and no scenario is contemplated in which they would not—suggesting that no such scenario would maximize the return on these intangibles. This often occurs in arm's length scenarios.

However, in controlled contexts, cases where two separate parties contribute different intangibles are more common, raising challenging valuation issues. Here, a profit split is often required; the draft defers much to Chapter II on this subject. These comments will explore some variations on concepts related to profit splits, drawing from contexts outside of transfer pricing and controlled transactions.

As in Example 19, unrelated parties negotiate by formulating their own separate analyses of the returns related to their investments associated with a transaction. The acceptable threshold for investment in the transaction is that the return is equal to or better than the company's alternatives when using the same or similar assets and resources. At arm's length, the views of *both* parties must be taken into account, as both perspectives form the negotiating positions that ultimately produce an arm's length result.

Furthermore, independent parties do not value the total transaction in the same way, much less with respect to each of the underlying intangibles or other assets combined in such a transaction. They will likely exchange forecasts and other information necessary in negotiating the deal, but they will not necessarily share equal views and assumptions regarding such information. After a negotiation, the only agreed arm's length value is the actual transaction price.

Identification of Parties Entitled to Intangible Related Returns

Valuable Contributions and Ownership of Intangibles

Immediately preceding Section B on page 12 of the Discussion Draft is a request for comments in bold type. This request (referred to here as the "preamble" for convenience) describes potential frameworks for this section of a revised Chapter VI, including continued use of a concept of "intangible related returns" which "should follow the contributions to the value of intangibles" (i.e., the current draft approach).

The term "contribution" as used in the preamble is potentially significant, but unclear. There are overlapping relationships with the use of this term in Chapter VIII on cost

contribution arrangements (CCAs), as well as in Chapter II on profit split methods. It is worth paying attention to how the term *contribution* is applied across these areas.

In a more general context, a "contribution" (of either cash, property or services) helps form the basis of relative ownership interests in the formation of a startup company, a partnership, a joint venture or a similar enterprise consisting of multiple owner/participants. In such contexts, the significance of member contributions is clearly reflected in relevant legal documents, such as in the operating agreement of a limited liability company (LLC) under U.S. law, under which the capital accounts and profits interests of members are aligned with their contributions.

Thus, the preamble may suggest that key roles and responsibilities discussed in the draft (e.g., paragraphs 41 and 54) may constitute a *contribution* that "entitles an entity […] to retain the benefits or returns with respect to intangibles […]." Such a contribution may result in an effective ownership interest; that is, an entitlement to intangible related returns. In contrast, a legal owner of IP or an entity that bears intangible development costs "without more," is not so entitled, according to the preamble.

Of significance to this project is this very last point, which illustrates consistency issues that should be addressed between the draft and Chapter VIII. Currently, Chapter VIII describes cash contributions as resulting in an "effective ownership interest" in the intangibles developed by a CCA. However, this would not meet with the Section B requirements for entitlement to intangible related returns.

In Section B, functions performed, assets used and risks borne remain important, but they may not alone be sufficient to entitle the relevant parties to returns from intangibles, unless they are considered *relevant* to creating value in the subject intangibles and thus are themselves seen as a *contribution*. However this *contribution* terminology is intended for the purposes of draft Chapter VI, there are also other issues to consider.

For example, Chapter VIII of the OECD guidelines regarding "cost contribution arrangements" uses the term *contribution* in both a limited sense (i.e., bearing costs) and a broader sense, including contributions "in cash or in kind" (i.e., services, intangibles and other property). Further, in a profit split method context (Chapter II), a "contribution analysis" is sometimes required to determine the proper division of profits among affiliates engaged in a transaction according to the "relative value of the functions performed (taking into account assets used and risks assumed)" by each of them. Here, less potential inconsistency arises from the current draft Section B, because a profit split method is considered best suited to situations where both parties contribute valuable intangibles; it is less likely that these contributions fall below the threshold criteria for returns from intangibles envisioned by draft Section B.

Thus, variations on the concept of value contribution appear elsewhere in the OECD guidelines. This project should ensure that there is consistency between the revised Chapter

VI guidelines and these other areas (which likewise may require revision). Furthermore, it is also worth considering the concept of a contribution as it pertains to other contexts outside of transfer pricing analysis. At least for illustration purposes, these may offer analogies relating to entitlement to intangible related returns under a revised Chapter VI. These will be revisited in later comments.

Section B also puts in place a fairly extensive description of responsibilities that entitle a party to intangible related returns, including an enhanced concept of *control* that connotes key decision making and risk taking activities. Paragraphs 40 and 41 note that an entitled party will in some cases "physically" perform certain of these key functions, listing examples that demonstrate a capacity to make strategic decisions, "design", "control" and "manage" key functions such as R&D programs and related budgets, "protect" the rights in intangibles, and maintain quality control over others that have been delegated to implement decisions and perform functions in a subordinate role.

The following items are identified along a continuum of roles and activities that may (but, in some cases, may not alone) lead to entitlement to returns from intangibles:

A. Legal ownership of legally and contractually protected intangibles,

B. Bearing costs in activities and assets that create intangible value,

C. Performing functions that may have a material effect on the value of an intangible, and

D. Strategic decision making, management and control over functions, assets and risk taking that generate and protect intangible value.

In its current draft form, Section B requires *more than* items A or B (either together or alone) in entitling a related party to intangible related returns. Neither legal ownership nor bearing intangible development costs qualifies an entity to retain the benefits or returns with respect to intangibles "without more," putting a question mark on many R&D-focused CCA participants.

While item D clearly qualifies (e.g., as in paragraphs 40 and 41), it also appears that item C alone is insufficient. For example, *performing* R&D does not appear to rise to the level of entitlement to the intangible value it creates, according to the draft. The party would also have to manage and control the R&D function, make key decisions regarding research programs such as when to start, continue, and stop them, have control over the R&D budget and contractual obligations of team members, and other similar items. All of these are encompassed in item D but not necessarily in item C.

Thus, entitlement to intangible related returns results from a very proactive role in managing and controlling the creation and development of intangibles, bearing related risks and costs, and carrying out the other activities necessary to stay in control of these key assets.

These attributes reflect those of an *active owner* and they comport with examples commonly seen at arm's length. For example, the draft emphasises the authority and the ability to make *decisions* regarding the intangibles and related activities, and bear the consequences (i.e., risks) of those decisions and their effects on returns. Additionally, this decision-making capacity is distinguished from "day to day" management that has been delegated authority but does not have ultimate control over critical decisions and strategy, for example.

The draft does not appear to recognize more passive forms of entitlement to returns, such as financial ownership without an active management role. Many of the functional and risk profiles commonly seen among MNEs today would potentially fail these strict criteria as well, raising the threat of controversy if they are ultimately adopted.

A shareholder analogy: entitlement to residual profits

A very common *ownership* relationship is one between equity holders in a corporation, and the corporation itself and its creditors. This relationship is useful in illustrating aspects of Section B and the draft in general. While the analogy may not fully conform to this transfer pricing context, both similarities *and* differences between Section B and the shareholder analogy offer important insights.[4]

The shareholder and the party entitled to returns from intangibles (hereafter referred to as an "entitled party") share some important features, including:

1) Claims on residual profits (and losses) from business assets or activities,
2) Bearing substantial risks related to item 1,
3) Returns subordinated to lower risk creditors and other entities (e.g., debt holders, suppliers, services providers),
4) Delegate business and management functions to others,
5) Have an element of control over delegated management (e.g., voting rights), and
6) May contribute cash to receive ownership interests / entitlement to returns.

The shareholder and the entitled party also lack commonality with respect to the following attributes of the latter, as specified in Section B:

[4] Credit for offering similar analogies between debt holders and parties earning limited risk returns goes to various colleagues over the years. In addition, this analogy is offered for illustration purposes only. Consistent with the draft's views on other analogies, it is not meant to introduce or suggest any differences in tax effects based on actual treatment of debt or equity under any tax law.

7) Actively control and manage functions, assets and risks,
8) Physically perform key functions related to item 7,
9) Strategic decision making, and
10) *Must* contribute more than cash, including valuable functions, assets or other activities that generate or help manage and protect intangibles.

Items 6 and 10 illustrate different contribution criteria for obtaining an "effective ownership interest" an intangibles development activity under Chapter VIII and draft Chapter VI, respectively. The former, consistent with item 6 above, reflects a passive equity interest bearing financial risk but not performing key control functions. Items 1 through 4 are also consistent with this profile. Given the long-standing nature of CCAs under the current Chapter VIII, it is unclear whether the strict criteria the draft are intended to relate to such CCA participants, or whether safe harbors would be recommended if these or similar criteria were ultimately adopted.

Contract R&D is also illustrated by the shareholder analogy, if indirectly with respect to item 3—i.e., a lower risk services provider with an assured recovery of its costs and an ability to earn a cost-plus markup. As noted previously, in Section B this activity does not earn an intangibles return—nor would it in this analogy—even if it generates intangibles for entitled parties. Like a debt holder, such an entity has chosen to forego variable returns associated with its business activity in order to receive a predictably steady return. This illustrates risk-return tradeoffs faced daily in capital markets, which reflect many other key elements of arm's length behavior.

Determining Arm's Length Conditions in Cases Involving Intangibles

Options Realistically Available

Section D.1.(i) clearly lays out an essential concept in arm's length transactions: taking into account the options realistically available to the parties. It is fundamental to the behavior of independent parties to compare alternatives and look for the best value at the best price. Additionally, no decision is taken that independent parties foresee would leave them worse off than if they had done nothing at all. These core concepts are well-addressed in the OECD guidelines in multiple areas, including draft Chapter VI, Section D.1(i).

Realistic alternatives undoubtedly inform independent parties' decisions about what they will willingly pay (or receive) for goods, services, property and property rights. This is true regardless of whether or not a party to the transaction would actually choose a particular option. The option may be meaningful to the other party, or to neither of the transacting parties directly, but to the market at large. In this sense, options realistically available may be hypothetical, but they have very real effects on prices. Such opportunity costs (and benefits) are not fiction – they largely inform most commercial activity (consider comparison shopping, capital budgeting decisions, or alternatives like renting *versus* buying a home).

Timing and risk effects on relative contributions

Comments on sections C.2(ii) and (iii) regarding transfers of intangibles in combination and with other items are provided above. Overall, the descriptions provided in these sections strike a reasonable balance regarding when such intangibles can be transferred and/or analyzed separately and when they cannot. The section also gives due attention to the "economic consequences of interactions between different intangibles" and potentially between other contributions as well, whether they are intangibles or otherwise. Here, a profit split remains a primary solution, as discussed elsewhere.

The following comments focus primarily on *timing* and *risk* issues. Paragraph 68 also provides relevant insights here. There is a sequential relationship in the processes of 1) performing research and securing a patent, 2) testing and regulatory approval, and 3) use of a trademark and related marketing activities to sell an approved product. To a degree, these stages of development must be concluded in this order—although they may each progress in a non-linear fashion. If different parties are responsible for such activities and risks, the timing of their risks will have an important bearing on their relative value contributions.

Other timing effects relate to competitive conditions and are addressed in the context of comparability factors in paragraphs 92 and 93, regarding exclusivity in rights, and the extent and duration of legal protection of intangibles (e.g., patents). These are also addressed below.

A relay race analogy

To elaborate on these timing and risk effects, a relay race provides a useful analogy. Here, each time-based competitive factor represents a "runner" and each exchange of the baton represents a transition in competitive advantage (e.g., obtaining a patent). In reality, aspects of the competitive transitions in this analogy can occur in parallel. This allows a successful relay team to build upon its advantages in a 'no holds barred' way (e.g., runners can share multiple batons; Olympic rules do not apply).

So, for example, Runner 1 could represent the invention and patent approval stage, Runner 2 the duration of the exclusive rights from the patent, Runner 3 the commercialization and brand development stage, and Runner 4 the post-patent stage. The race proceeds as follows:

> Runner 1 gives the team a head start in the new product area (i.e., an approved patent). Runner 2 (i.e., patent duration) substantially extends the team's lead over all competitors. In fact, Runner 2 throws an extra baton ahead to Runner 3 (i.e., commercialization and branding), giving him a major head start. Before competitors have even left the starting block, the technology and market lead gains by runners 1, 2 and 3 are becoming insurmountable. When competitors do leave the starting block, Runner 2 obstructs them—as is his role under the rules. Finally, when Runner 4 takes the baton and Runner 2 sits down (i.e., patent expires), the team is already successful.

> Runner 3 carries Runner 4 over the finish line to victory. Meanwhile, the team re-enters (i.e., reinvests) in multiple additional races – with runners 1, 2 and 3 interacting to extend large leads and again realize similar gold medal outcomes.

Useful life and stages of development

The use of this relay race analogy may be extended to paragraphs 95 and 96 regarding *useful life* of intangibles, which too may be extended. This is of great significance in the contexts of timing related competitive advantages. Factoring in *stages of development* and *rights to enhancements* further explains such advantages.[5]

It is often misconstrued that because one can hypothesize a halt in the development of commercially successful technology that this should affect the *value* of such intangibles, even when no ceasing of intangible development is contemplated. Stopping development would only diminish the value of the technology owners' assets, making them worse off, not unlike stopping in the middle of a race when one is winning. While "possible," this not a viable option for the owners of such intangibles. Ironically, however, such assumptions often affect the valuation of contributions to CCAs set up for the purposes of *continuing* development of intangibles in the same and similar areas. This is a clear contextual mismatch. The draft covers aspects of related issues as is appropriate.[6]

Limited useful life assumptions can artificially isolate intangibles into "before" and "after" development stages that in reality are ongoing and as interrelated as runners 1 through 4 in the analogy above (or even more so). Often, such assumptions are accompanied by a disregard for the value of development rights and the restrictions commonly imposed on them.

A technology's value as a base for ongoing research may often extend to other commercial uses in yet unexploited product areas or fields of use. In areas like software technology, an installed base of existing users of a current generation product can be used to develop and market later software enhancements, updates and versions. Even shorter term technological advances may result in long term market advantages, just as the first runner in a relay race may create advantages for his team that extend to each subsequent stage in the race.

Thus, a limited life analysis should not dictate the duration of the market advantages that a technology helps create. When such advantages are coupled with development rights they may extend well beyond any measure of current product life. Some products, like software, effectively rely on a continuous development process, with each subsequent

[5] Section D

[6] For example, paragraphs 95 and 96 discuss the potential that continuing development extends the useful life of existing intangibles, 143 and 144 discuss difficulties in assessing risks borne before and after partially developed intangibles are transferred, and 165 to 167 address useful life assumptions and the potential future benefits realized from an intangible after it has expired (as demonstrated by the patent in the relay race analogy illustrated in these comments).

generation built upon predecessor technology. Misconceptions about these issues also had a major effect in *Veritas.* Examples that correct this contextual mismatched are discussed below.

Paragraph 102 also deals with the risks related to future development of intangibles and obsolescence issues, if such development does not keep up a pace ahead of competition. Such risks speak to the importance of technology research leads (however short or long) and continued development efforts in competitive markets. Rights to carry on such development are valuable to their owners and rarely intentionally shared with potential competitors.

With respect to software intangibles, paragraphs 74, 99 and 100 address the interaction between rights to use software and rights to receive ongoing support and periodic updates to that software. Rights in software and updates are usually inextricably linked. The notion that rights to updates can be transferred *without* taking into account rights to use the software itself is virtually unheard of in uncontrolled software license contexts. The value of updates is interdependent with the value of the software intangibles. It should be obvious that these concepts further relate to development rights, including the rights to create updates, modifications, and subsequent versions of software or similar technology. Paragraph 100 reflects these issues, which also affected the outcome of the *Veritas* case.

Using valuation techniques under arm's length conditions[7]

As the draft states, a net present value (NPV) analysis that discounts future income streams should be applied from the perspectives of *both* parties to a transaction (e.g., see paragraph 148). NPV analysis is usually necessary to make an "apples to apples" comparison, given that different options may produce varying income streams and/or benefits realized over different time intervals, and facing different risks. Thus, the available options are compared on a present value basis in order to put them in the same context.

Alternatively, an analysis may rely upon market prices for the same or similar items—e.g., a comparable uncontrolled price (CUP) analysis as defined in Chapter II. A common example here is the acquisition price of an independent company focused on the same or similar technology as the controlled transaction.

It should be recognized that when valuing any single asset or investment, *both* an NPV and a market price analysis are implicit and, depending on the availability and reliability of data, both approaches may be explicitly applied. For example, in the acquisition price scenario, both the buyer and the seller would have valued the target company with each likely applying an NPV (i.e., discounted cash flow) analysis. The negotiated market price derives directly from these NPV analyses, as is well-demonstrated in Example 19.

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[7] Sections D.2 and D.4

The share price of an individual stock provides another example of the nexus between NPV and market price analysis. At any point in time, the share price reflects the expected future returns associated with that asset. Stocks are constantly revalued based on new information—as reflected in changes in traded share prices. This market value thus exists precisely because cumulative expectations about a company's future earnings and dividends are so closely reviewed by investors, along with past performance.

In this broad sense, present value analysis and market price analysis are as interrelated as day and night. Conceptually, it is hard to imagine that one exists without the other, at least implicitly—even if the availability of reliable data does not always lend itself to applying both approaches.

Timing, Risk and Rights to Development

Transfer pricing raises difficult timing and risk questions with respect to valuation, as addressed in paragraphs 143 and 144, for example. One party (Company X) may undertake the initial R&D and commercialization process while another (Company Y) may contribute to later development and updated versions. Here, the relative contribution of different intangibles types is less the issue. It is the timing of the development activities and related risks undertaken by different parties that must be weighed.

Some analyses effectively try to separate the contribution of Company X in period 1 from the combined contributions of X and Y in period 2. Essentially, this asks the rhetorical question, "Which hand claps the loudest? The 'before-hand' or the 'after-hand?'[8] Usually, the answer is wrong because the question is wrong. The question from Company X's perspective is simply to determine which of its options is most valuable. Company Y will do the same, and if the two parties' analyses overlap within a reasonable range a deal might occur somewhere in between.

Tying this back to the same process used in Example 19, we see that the software intangibles need not be separated into those that exist exclusively "before" and "after" the transaction. Like the share price of a stock discussed above, the value of the software results from an integrated view of these periods. Furthermore, no one really contemplates discontinuing the software's development in any event. Thus, Company X (the owner/transferor) compares the present values of two income streams that reflect its options:[9]

A. continuing development, maintenance and exploitation of the software alone (e.g., its existing business model), *versus*

[8] This has been the subject of major transfer pricing controversy (e.g. *Veritas v. Commissioner*).
[9] Company X may face other alternatives as well, but these have been narrowed in this discussion for simplicity and illustration purposes.

B. joint development and ownership of future improvements and *all* related software intangibles with Company Y, effectively sharing the risks, costs and benefits of the intangibles from the date of the transaction forward.[10]

Note as well that *neither* of these scenarios need consider the useful life of the current generation software alone; it doesn't factor into these options which involve continuing its development.[11] Discontinuing development would simply waste these valuable assets.

Scenarios A and B both take into account everything known about the technology to date in weighing expectations about its future prospects: its stage of development; whether it has been successfully commercialized; and whether there are licensees and an installed base of users. If such past events have occurred, they inform and explain expectations regarding future outcomes used to determine the present value of the assets.

Company Y (the transferee in the negotiation) may downplay or dismiss the value of the assets developed to date and weigh its own contributions under scenario B more heavily. It may try making a case for valuing some intangibles at cost as part of the negotiation process. But an arm's length agreement is only reached when *both* parties agree—the individual perspective of just one of the parties does not determine an arm's length result. Company X's forecast modeling is far less likely to see such cost-based methods as realistic options for pricing its intangibles.

The critical distinctions between market value and replacement costs with respect to intangibles are well described in paragraphs 112 and 113. The latter also emphasizes the related timing effects discussed above in the relay race analogy when noting,

> […I]t is necessary to evaluate the effect of **time delays** associated with deferred development on the value of the intangibles. Often, there may be a significant first mover advantage in having a product on the market at an early date. As a result, an identical product (and the supporting intangibles) developed in future periods will not be as valuable as the same product (and the supporting intangibles) available currently.

In competitive technology industries, such time delays would often render a replacement cost approach an unrealistic scenario for prudent investment. The replicated technology or workforce, for example, may never catch up with the market success or development lead achieved by the first mover, particularly if the latter obtains patents.

[10] Both parties would perform such an analysis, which would take into account their respective contributions as well.

[11] The option to abandon (or expand) a project is always present and contributes further to the option value of R&D projects and similar activities. This is true in the case of either A or B, but weighted less heavily when the project is achieving commercial success as in this example.

A Range of Valuation Contexts

Intangibles valuation is done in a range of contexts at arm's length. At one end of this spectrum are market transactions involving intangibles – such as transfer of intangibles via a sale or license, and/or joint ventures and mergers involving parties with intangible assets operating as a going concern. The other end of the spectrum would include a bankruptcy context and/or liquidation of assets including intangibles.

It should be obvious that under these two extremes one would expect the highest and lowest valuations, respectively, for any intangibles (and other assets) that might be transacted, all else being equal. What also characterizes transactions along this contextual spectrum is the degree to which intangible assets operate collectively in a manner that either demonstrates or promises commercial success. In contrast, when an enterprise is in liquidation, its assets are disposed of separately and, in general, are subject to the lowest valuations.

These issues speak to the appropriate uses of net present value and market price-based analyses when intangibles:

1) are commercially successful or arising from a proven track record of development, and/or

2) operate and are transacted collectively.

The earlier discussion regarding NPV and market price analysis also relates to the potential use of more than one method, as addressed in paragraphs 114 of the draft and 2.11 of Chapter II in the guidelines. While Chapter II does not require use of multiple methods, the potential merits for comparing the results derived from NPV and market-based analyses are noteworthy, given the conceptual relationship between them. As paragraph 2.11 notes, a flexible approach that considers more than one method may be useful when sufficient information is available.

An important *caveat* in using multiple methods is avoiding a mismatch of contexts in combining separate valuation methods to arrive at an itemized total price for a transfer such as an intangibles contribution under a CCA. For example, a large disparity in results when comparing an NPV- or market price-based analysis of a group of intangibles with a "buildup" approach using various separately applied valuation methods for each individual intangible is revealing. One of the two approaches must be out of context with the actual transaction, especially if the buildup approach used cost- rather than market-based methods, or applied a CUP involving limited rights as if they were very broad.

Value additivity is a core tenet of finance theory that is helpful in revealing such problems when they are presented. This basic concept essentially states,

$$PV(A) + PV(B) = PV(A,B)$$

If one is to isolate the present values of separate individual assets that operate and are transacted collectively, the sum of these individual parts must equal the whole. If they do not, something has been undervalued or is missing from the equation. Alternatively, when it is possible to determine the present value of *A* and *B* combined through an aggregate method, it will make more sense to do so in such cases. Even if items *A* or *B* can be valued separately, the sum of these separate valuations should be compared to an aggregate method to assess any differences and enable fuller consideration of the methods, data and assumptions used in such analyses.

Profit splits and insights in other contexts

There is much common ground between IP infringement damages estimation and transfer pricing analysis of intangibles as described in existing and draft OECD guidance. This should not be surprising, because both concern intangibles and the hypothetical processes that underlie each (i.e. "but for" analysis and the arm's length standard) are grounded in the same economic principles.

In IP damages contexts, as in transfer pricing, facts and circumstances and the resources, capabilities and market conditions faced by the parties weigh heavily in the analysis, as do the uniqueness of the IP and its profit potential.

Interrelationships among other activities and assets are also highly relevant to this discussion, despite the fact that IP infringement damages often relate to a single intangible asset (e.g. a patent). IP damages analyses also consider interrelated assets (including production assets and potentially other intangible assets), related products and business activities, services, contributions of other parties, and other options available to both the IP owner and the infringer. Moreover, IP damages are calculated on a base of infringing product revenue that derives from the assets and resources of an entire business, in addition to the IP itself. This all sounds consistent with issues from a transfer pricing context.

Two primary approaches are used to calculate IP infringement damages: the "lost profits" method and the "reasonable royalty" method. The former measures the incremental profits lost to the IP owner that would have been earned "but for" the infringement—i.e. profits on infringed sales. The standard for awarding lost profits is higher than that for a reasonable royalty, requiring proof there were no non-infringing substitutes and that the IP owner had the capability (e.g. production capacity, distribution networks) to meet demand related to the infringing products.[12]

[12] Four criteria applied in finding "lost profits" are collectively referred to as the *Panduit test* after *Panduit Corp. v. Stahlin Brothers Fibre Works, Inc.* in which they were outlined. The other two include proving the existence of demand for the patented product, and proof of the amount of profit lost per lost sale.

If lost profits cannot be proven, the floor on damages is based upon a "reasonable royalty" determined based on 14 criteria that closely resemble the application of a CUP method in Chapter II.[13] Items 1 and 2, respectively, are the existence, if any, of an established royalty received by the licensor for the same IP; and rates paid by the licensee for any similar IP. Item 3 asks the nature and scope of these licenses, including any restricted or non-restricted terms. Other items go down similar paths—i.e. a form of CUP analysis.

Having established comparable IP and royalty rates, the analysis turns to the commercial relationship of the licensor and licensee and whether they are competitors or collaborative (item 4). Interrelationships between patented and unpatented products and derivative business (i.e. "convoyed sales") are then considered (item 6). Various other factors regarding both the IP itself and evidence found in comparable licenses are weighed as well.

Item 13 requires a form of a residual profit analysis. This factor allocates "but for" profits across elements that are not patented, such as services provided with the product, manufacturing processes and costs, business risks, as well as other product or feature improvements that may have been contributed by the infringer and not the IP. In other cases, infringement damages are computed by directly deducting a "normal" rate of profit earned on the infringer's other product sales from the total profit on infringed sales. The residual forms a basis for IP profit.

Not unlike Example 19 in the draft, the reasonable royalty calculation weighs all of these factors and the opportunity costs (i.e. other options available) to *both* parties. A hypothetical license negotiation is premised on the minimum and maximum acceptable royalties for the licensor and licensee, given their best available alternatives.

In IP infringement suits, one of the more contentious issues is how to split the "residual" represented by the range of royalties both parties would be willing to pay (receive). Here, the guidance from case law remains somewhat limited. Nevertheless, the assets, resources and capabilities of the infringer are weighed, and it is always assumed that some of the compensation should go to his hypothetical non-infringing sales that would have occurred in a "but for" scenario.

Thus, opportunity costs weigh heavily in these analyses as well; they can relate to either or both parties and cut either way. For example, the availability of substitutes cuts into the amount of infringed sales, reducing the award to the IP owner (i.e. assuming that absent the use of the infringed IP the infringer would have used an alternative technology). Additionally, the IP owner may have lost sales of products related to the patented product ("convoyed sales") and lost profits from these sales can increase its award (even though the infringer and other sellers did not infringe with respect to such related products).

[13] Referred to as the *Georgia-Pacific* Factors, these derive from case law resulting from *Georgia-Pacific Corp. v. U.S. Plywood Corp.*

Weighing the relative contributions of various items is often a challenge where IP-related disputes are concerned, not unlike in transfer pricing contexts.

SECTION C: *Transactions involving the use or transfer of intangibles*

Competitive conditions and their impact on intangible rights transfers

As discussed in paragraph 65 and relevant references in Chapter I (e.g., paragraphs 1.67 to 1.69), conflicting interests are common between independent parties but are not naturally present among affiliates in a controlled context. The effects of such differences have on comparisons of controlled and uncontrolled transactions must be taken into account in arm's length analysis.

It is often the case that independent parties license intangibles to competitors and potential competitors. Thus, some of the most common provisions in licensing agreements relate directly to competitive concerns and seek to block the potential that the licensee could compete with the licensor with respect to the intangibles, erode the proprietary nature of the licensed intangible and thus diminish its value, and/or create alternatives that displace the need to continue to pay for a license.

Without addressing competitive conditions *per se*, subsection C.2(i) (i.e. para. 62-65) addresses important issues that result from these conditions as faced by independent parties to uncontrolled intangibles transactions. For example, competitive concerns contribute to a tension between the scope of rights in intangibles that are transferred, on the one hand, and restrictions that the licensor imposes on the licensee with respect to those rights—in particular, restrictions on rights to further develop intangibles.

Restrictions on development rights prevent competition on the part of licensees that have not yet developed the same or similar intangibles to those under the license, but have significant financial and technical capability as well as a potential interest in doing so. As often seen in technology industries, a licensee of third party developed solutions may ultimately enter the market of the licensor, perhaps by acquisition or other means, resulting in a range of potential conflicts. These issues fundamentally relate to competitive conditions between uncontrolled parties to intangibles transactions.

Aspects of this issue are addressed in the current draft, for example in paragraph 63 which highlights the need to understand the specifics of the rights transferred, *as well as* "limitations and the full extent of rights transferred." However, this statement could be clarified to say "limitations and restrictions and the full extent of the rights that are and are not transferred."

Although paragraph 64 allows for a range of potential rights transfers depending on the facts and circumstances, contextual mismatches related to development rights have had a

significant effect on the outcomes in transfer pricing controversies. One such mismatch is the use of uncontrolled limited license transactions with licensees known to be competitors or potential competitors to the licensor as comparable to a controlled transaction involving a transfer of development rights as part of a contribution under a CCA.

In the former (uncontrolled) case, the restrictions and limitations imposed on the licensee are typically substantial, both contractually and in practice, particularly with respect to any rights related to further development of licensed intangibles. In the latter (controlled) example, a significant interest in such development rights is exchanged outright under the CCA, along with an "effective ownership interest" in intangibles that will be developed using those rights. Relying on the uncontrolled transaction to value this controlled transaction can result in substantial undervaluation of such a contribution.

Depending on the facts and circumstances and the availability and reliability of data and assumptions, it is possible that such a comparability mismatch can be overcome with adjustments, although this is not a simple or straightforward matter. In any event, when an analysis does not take such differences into account, a contextual mismatch remains between the uncontrolled and controlled transactions, with potentially dramatic effects on valuation.

In reality, if the development rights and other broad rights granted in the controlled context (i.e., the CCA contribution) were granted to an uncontrolled licensee, the potential shift in competitive advantages could be disastrous for the licensor's business. The magnitude of such effects are often exemplified in IP disputes regarding alleged infringement which, though contextually different, carry in mind many of the competitive conditions and effects contemplated in undisputed license agreements. Many license provisions discussed above are meant to head off such disputes and protect the licensor.

The second part of paragraph 64 is also worthy of a comment. In the analysis of uncontrolled licenses in the software industry, there can be misperceptions about the extent to which "the transferee/licensee retains the right to any enhancements it may develop, either for the term of its license or in perpetuity."

In my experience negotiating (arm's length) license agreements, the appearance of such rights in uncontrolled agreements often relates to a minor subset of technology rights that, in contrast to the licensor's core technologies, are less valuable to the licensor when kept proprietary. These can include, for example, an application program interface and source code for a client device (i.e., a remote software or hardware device) that integrates with the licensee's (and not the licensor's) core product or technology.[14] In such cases the licensor's core base of source code usually remains unseen and untouched by the licensee.

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[14] Client devices include software applications and hardware devices that connect with (or "talk to") centralized software code on remote servers and databases, all of which, in contrast, most often remain fully proprietary to the licensor with restricted and limited rights granted to licensees.

Thus, client code development rights are often only pertinent to the licensee's products to facilitate easier implementation for the licensee at less cost to the licensor (i.e., it is an exceptional case when development rights are less valuable when kept proprietary). Suffice to say, *valuable* development rights in a licensor's key software technology are kept proprietary and rarely, if ever, intentionally made available to uncontrolled licensees at arm's length.

Maintaining such control is not a simple or straightforward matter, either. The management roles, responsibilities and risks involved in protecting such rights have been addressed in draft Section B already, as discussed above.