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The OECD Discussion Draft on Intangibles And the Myth of Unavailable Comparables

The authors argue that the Organization for Economic Cooperation and Development's revised discussion draft on intangibles lacks guidance on the available market evidence to answer the central question of an arm's-length analysis: How would independent parties act given the tested transactions' facts and circumstances? Asserting that ample evidence for this analysis exists in the form of license agreements and royalty rate structures, they warn that failure to use this data constitutes a lack of due diligence.

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As providers of intellectual property intelligence to corporations' IP, legal, and research and development departments, the authors have been able to witness licensing negotiations taking place between independent entities. These negotiations do not take place for transfer pricing or tax purposes; rather, they take place among business executives looking to maximize stakeholders' equity. These events have provided valuable insight into the way independent parties behave when dealing with transactions involving intangibles.

The Organization for Economic Cooperation and Development's July 30 revised discussion draft on intangibles[1] spends significant time asking, ''How would independent parties act given the tested transactions' facts and circumstances?'' However, the draft lacks guidance on what market evidence exists to determine an answer. Using experience from independent licensing negotiations, the authors hope to begin a discussion on this matter.

[1] See 22 *Transfer Pricing Report* 441, 8/8/13.

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Specifically, independent parties use market evidence:

- to determine the behaviors and deal structures (including functions performed, risks assumed and assets used) of independent parties to intangibles transactions, using more than 100,000 license agreements as potential comparables,[2] and
- to determine the arm's-length pricing in such transactions, using more than 60,000 disclosed royalty rate structures as potential comparables.[3]

Three Common Myths About Comparables

This discussion should begin by looking at some common myths surrounding comparables, correcting any misunderstanding, and providing transfer pricing practitioners with a better grasp of the facts related to the use of independent license agreements as benchmarks.

Myth 1: Global market information is not available

There is a common misconception that global license agreements—which may be used as comparable uncontrolled transactions—are not available. Based on the authors' research, more than 60 percent of publicly available license agreements include territories for regions *outside* the United States. Indeed, the public domain

[2] This number is based on research of license agreements as of September 2013.

[3] This number is based on research of disclosed royalty rates as of September 2013.

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contains uncontrolled license agreements for most regions and many countries.

Myth 2: Redacted license agreements have no value

There is also a common misconception that only unredacted license agreements provide value to transfer pricing analyses involving intangibles. To transfer pricing professionals, ''unredacted'' generally means that royalty rate information is published within the license agreement. Based on the authors' research, there are approximately 15,000 unredacted license agreements available in the public domain.[4]

Unfortunately, a transfer pricing practitioner who bases an analysis exclusively on 15,000 data points is likely missing the big picture. There are more than 100,000 license agreements available in the public domain. Despite the fact that most of these do not list actual royalty rates, they do contain various terms, deal structures, and divisions of functions and risks that can aid in the analysis of the arm's-length nature of tested transactions.

Basing a transfer pricing analysis on a subset of available data, such as only those license agreements with unredacted royalty terms, would be a disservice to clients and shareholders, effectively turning a blind eye to the majority of available market information. Through involvement in APA submissions, litigation and third-party license negotiations, the authors have first-hand experience working with experts who rely on too-small data sets, only to miss several key factors of comparability—factors that would have been evident after reviewing all comparable, publicly available agreements. As with any scientific approach, it is prudent for professionals to review all information available to them in order to provide a sound analysis.

Myth 3: The comparable uncontrolled price (CUP) method cannot be applied because perfect comparables do not exist

The OECD guidelines state a preference for comparable uncontrolled transactions; specifically, the CUP method is preferred over other methods. Of course, in practice, it becomes extremely difficult if not impossible to identify perfect comparables, especially when searching for comparable license agreements. This does not mean, however, that the CUP method should be rejected. The OECD guidelines state in Chapter 2 that ''where differences exist between the controlled and uncontrolled transactions or between the enterprises undertaking those transactions, it may be difficult to determine reasonably accurate adjustments to eliminate the effect on price. The difficulties that arise in attempting to make reasonably accurate adjustments should not routinely preclude the possible application of the CUP method.'' Furthermore, the OECD guidelines state that ''practical considerations dictate a more flexible approach to enable the CUP method to be used.''

A practical application of the CUP method—one that uses market evidence as a benchmark of how independent parties typically structure and price transactions involving intangibles—generally provides more-than-sufficient benchmarks to act as one part of a prudent transfer pricing analysis involving intangibles. While these benchmarks may not be perfectly comparable, they do offer guidance with respect to the tested intangibles transactions and provide professionals real-life negotiated data points for consideration.

A Practical Approach to Structuring and Pricing Intangibles Transactions

The authors agree with the OECD revised discussion draft that transfer pricing analyses of intangibles transactions should be ''the determination of the conditions that would be agreed upon between independent parties'' as well as dependent on ''evidence.'' The revised discussion draft does an excellent job referring to the OECD guidelines' preference for comparable uncontrolled transactions—specifically, the fact that the CUP method is preferred over other methods. Of course, in practice, it becomes extremely difficult if not impossible to identify perfect comparables. This does not mean, however, that the CUP method should be rejected.

The revised discussion draft has a recurring theme, best communicated in paragraph 40, which states that ''rather than focusing on accounting or legal definitions, the thrust of a transfer pricing analysis in a case involving intangibles should be the determination of the conditions that would be agreed upon between independent parties for a comparable transaction.'' This theme is repeated in various paragraphs, including paragraph 66 (which discusses arm's-length conditions), paragraph 74 (stating that all members of the group must receive appropriate compensation for any functions they perform, assets they use and risks they assume in connection with the development, enhancement, maintenance and protection of intangibles), and the introduction to the revised discussion draft (on the recharacterization of transactions that might not occur between unrelated parties, which is listed as one of the actions designed to combat base erosion and profit shifting). In fact, the real theme of the revised discussion draft can be summarized by one question: How would independent parties behave given the tested transactions' facts and circumstances?

The OECD guidelines state in Chapter 2 that ''where differences exist between the controlled and uncontrolled transactions or between the enterprises undertaking those transactions . . . [these differences] or the difficulties that arise in attempting to make adjustments should not routinely preclude the possible application of the CUP method.'' Furthermore, the guidelines state that ''practical considerations dictate a more flexible approach to enable the CUP method to be used.'' In other words, the CUP method can serve as a good indicator or benchmark of deal structures and pricing structures for intangibles transactions.

This concept is not unlike using comparables when purchasing a house (see Exhibit 1). The house next door is similar, but it has a better kitchen. The house down the block is also similar, but it has updated floors. The house in the next neighborhood is spot on, but it is in the wrong neighborhood. While not perfect comparables, all of these serve as benchmarks for the price of the house.

Similarly, the use of comparables for intangibles analyses provides much needed transparency regarding independent-party deal structures, the functions per-

[4] This number is based on research as of September 2013.

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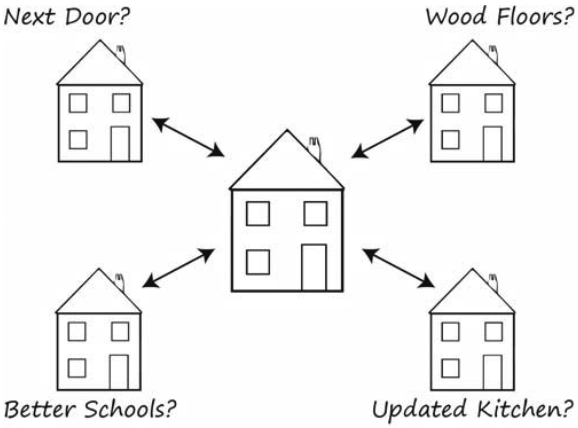
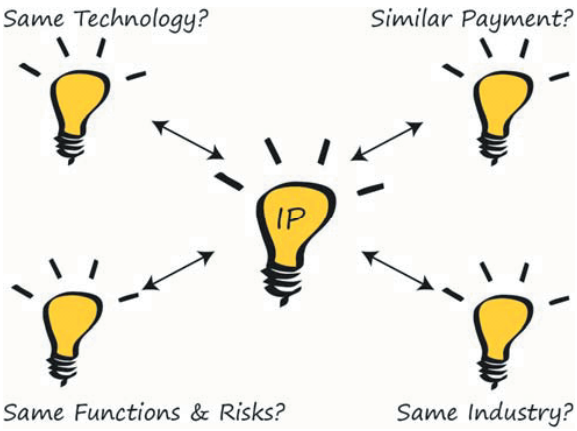
Exhibit 1: The CUP Method…In a Practical Way



formed, the risks assumed and the payments made (see Exhibit 2). In fact, based on the authors' experience, the practical application of the CUP method generally provides more-than-sufficient benchmarks to act as one part of a prudent transfer pricing analysis involving intangibles. While these benchmarks may not be perfectly comparable, they do offer guidance and provide experts with real-life negotiated data points for consideration.

Exhibit 2: The CUP Method…In a Practical Way

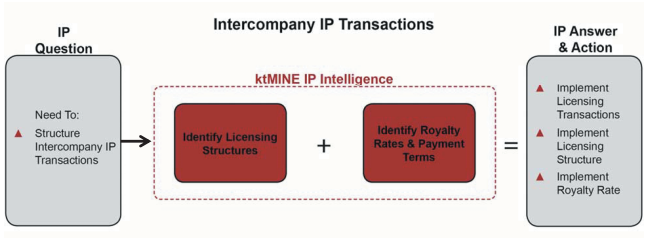


Having access to *all* possible information is critical for an intangibles analyses. It should be noted that there are really two questions posed by the revised discussion draft:

- How would independent parties structure an intangibles transaction given the tested transactions' facts and circumstances? And
- What price would be agreed upon given this structure?

Determining the deal structure of an intangibles transaction is separate and distinct from the process for determining the price for use or transfer of the intangible (see Exhibit 3). Fortunately, there are two categories of data that are useful in answering these important questions.

Exhibit 3: Two Step Process For Determining Deal Structures & Arm's Length Pricing



Step 1: Determine deal structures—how does the market structure intangibles transactions?

There are more than 100,000 license agreements available in the public domain encompassing all deal terms and conditions that should be used as market evidence. This licensing intelligence can be used to identify market evidence of deal structures typical among independent parties. Historically, these license agreements were wrongfully ignored because most practitioners did not know they existed.

The use of these 100,000 license agreements provides transparency to independent-party deal structures—specifically, the functions performed, risks assumed and payment terms agreed to by independent parties. This data can be used as benchmarks to structure related-party transactions involving intangibles and to identify market behaviors for the examples in the revised discussion draft. With this market evidence, experts can better answer any structural questions including:

- Do third parties share significant fluctuation in the foreign exchange rates?
- Would a licensee ever pay to register the licensor's trademark in the licensed territory?
- How do third parties share rebates?
- Would a licensee bear warranty risk and product liability risk for its territory?
- Would third parties set a royalty rate to increase as the sales of the licensee increase?

Step 2: Determine pricing structures—how does the market price intangibles transactions?

There are more than 60,000 disclosed royalty rate structures available in the public domain, including those done on the basis of gross sales, net sales, gross profits, operating profits and cost plus, as well as commission payments, sublicense payments and various other payment structures.

The use of these 60,000 disclosed royalty rate structures provides market evidence of prices typical among independent parties. This set of data is meant to assist in the determination of comparable royalty rates for intercompany transactions involving intangibles and is searchable by various factors of comparability, including type of intangibles, industry and exclusivity. Used in conjunction with a prudent analysis that considers factors of comparability, these data points can provide excellent market evidence of intangible value.

Conclusion

Whether classifying the CUP method as a primary method, corroborative method or rejected method,

proper due diligence dictates determining the answer to the question of how independent parties would behave given the tested transactions' facts and circumstances. Market evidence exists in the form of more than 100,000 license agreements and more than 60,000 disclosed royalty rate structures to help answer this question. By failing to examine the behaviors of the market, taxpayers and practitioners are not exercising proper due diligence to complete a prudent arm's-length analysis.

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