IP facts you can't afford to miss…but you probably do

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As a transfer pricing practitioner, having access to *all* possible information is not only critical for your IP analysis, but ultimately your reputation as an expert. Yet the alarming reality is that most practitioners are forming their IP positions based on less than 25 percent of available information.

I. What you are missing…and the risk to your IP analysis

Information and expectations have changed when using uncontrolled transactions under the CUP Method, which has been cited as the OECD's preferred method for transfer pricing IP analyses.

Practitioners are not only expected to identify the correct arm's length royalty rates, they must also ensure that the structure, terms, and payments of their tested IP transactions align with those presented in third-party transactions. In fact, the OECD discussion draft stresses the question every expert should ask and prove out:

> what would third parties do given the tested transaction's facts and circumstances?

To answer this question, practitioners have historically relied on unredacted license agreements (i.e., license agreements containing published royalty rate payments) which are really meant to assist in determining comparable royalty rates. However, there is a great risk in relying purely on unredacted license agreements. This data pool only represents a small subset (less that 25 percent, in fact) of relevant information available and can greatly affect the resulting defensibility of an IP analysis.

Simply stated, the odds do not favor practitioners who do not make use of all available information. Currently, there are over 70,000 total license agreements digitally filed in the public domain, but only 13,000 or so unredacted license agreements. Given the substantial delta between total license agreements and unredacted license agreements, one can argue that reviewing the full universe of agreements gives experts a significant competitive advantage when defending their IP analyses by providing a more complete, and defensible, view of uncontrolled transactions.

Prudent experts are now expanding their research to include all licensing agreements to substantiate their IP analyses and protect their transfer pricing positions.

II. Who has the facts…and why you should too

Various tax authorities, litigators, and experts now know about the increased benefits of using the complete universe of license agreement information for IP analyses. In fact, the most sophisticated experts use the findings they gain from reviewing all licensing agreements to challenge the work of their counterparts and clench the lead position in controversy or negotiations.

Real-world examples:

- *Audit cases*: Tax authorities around the globe are looking for terms in all license agreements to assess "would third parties agree to such a fact pattern?" and then refute the taxpayers' position if evidence points to the contrary. Using all available license agreements provides access to a broader set of outcomes which often times may be missed by those using a subset of available information.
- *Controversy and litigation*: Experts are using all license agreements to challenge the opposition's position – generally based on unredacted information - by showing market evidence of a fact pattern that the opposition did not know existed. By presenting contrary, real-world evidence, these experts are able to gain a competitive advantage in such cases.
- *Advance pricing agreements*: Experts and tax authorities use all license agreements to provide market evidence of a particular fact pattern. By using a full set of uncontrolled transactions, experts have confidence in their assignment of functions performed and risks assumed, as well as payment structures common in an industry, thereby increasing the strength of their position submitted to a tax authority.

The examples above capture a few scenarios that make the case for more thorough examination of all license agreements in IP analyses. The full universe of licensing data can be used to answer countless questions involving the deal structure, functions performed, risks assumed, and payments made by parties to uncontrolled transactions. The answers to these questions can assist a practitioner in ensuring intercompany IP transactions are structured in a manner similar to those used by third parties. Some questions include:

- Would third parties expense stock options and share costs as part of a joint venture?
- 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?
- What is the exact make-up of a percentage sales royalty for a consumer retailer (i.e., are discounts and allowances included in the base)?
- Would third parties set a royalty rate to increase as the sales of the licensee increase?

III. How it looks in practice…and why you should apply best practice

Below are two case studies that further highlight the benefits of using all available licensing data when preparing IP analyses. These case studies represent two of the multitudes of situations where the deal structure, assigned functions, assigned risks, and payment structures of intercompany IP transactions can be challenged by experts who have conducted research using all available license agreements.

Case study 1

- A taxpayer executed an intercompany license agreement for the right to use a well-known patent portfolio.
- The structure of the intercompany license agreement was challenged by a prominent tax authority.
- Among other topics, the tax authority challenged the fact that a licensor and a licensee would not share foreign exchange fluctuations.
- The taxpayer hired a well-known transfer pricing consultant who prepared a report, using only unredacted licensing agreements, stating that no evidence exists in the public domain that shows third parties sharing foreign exchange fluctuations.
- The tax authority, using all licensing data, was able to find industry-specific situations where a third-party licensor and licensee would share foreign exchange fluctuations and the manner in which this would occur.
- Based on this fact pattern, the taxpayer was asked to make an appropriate adjustment.

Case study 2

- A well-respected transfer pricing firm prepared an APA submission involving the cross-border transfer of products, including bundled IP, for a well-known consumer brand company.
- As is common practice in the industry, the transfer pricing firm asked the company's tax department for an inventory of any internal CUPs, for which none were supplied.
- In fact, the company stated that no internal comparables exist because the company does not license the subject IP to third parties.
- In an effort to perform sound due diligence, the transfer pricing firm reviewed only unredacted agreements for potential internal comparables and external comparables. Only external comparables were identified.
- The APA submission was filed with this fact pattern.
- Using all license agreements, the tax authority searched for the company's name and identified not only one internal comparable for the exact product containing the exact IP, but also various sublicense agreements for use of the exact product containing the exact IP. The internal comparables showed a very different pricing structure than that proposed in the APA submission.

- Based on this fact pattern, the company and transfer pricing firm were asked to resubmit their APA using the internal comparables.

IV. Ensuring the same advantage…the best defence starts with a thorough offence

With the release of the OECD draft guidelines – which call for the modelling of intercompany IP transactions after comparable uncontrolled transactions – transfer pricing practitioners should protect themselves from greater scrutiny of their IP analyses by preparing solid studies using all available information in the public domain.

It is the author's belief that basing an IP analysis on a subset of available information would be a disservice to clients and shareholders as it turns a blind eye to the majority of market information available which could alter the final results. In my experience, I have been a part of APA submissions, litigation situations, and third-party license negotiations where one practitioner relies solely on unredacted licensing agreements, only to miss several key factors which would have been evident by reviewing all publicly-available agreements. As with any thorough scientific approach, it is prudent for practitioners to review all information available in order to provide a sound, accurate analysis.

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