CRA Insights: Transfer Pricing

CRA The Ballentine Barbera Group

Cost sharing and IP valuation: US vs Europe—The bottom line

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In this article, we compare and contrast the OECD Guidelines ("Guidelines") and regulations in Europe and the US with respect to intangible sharing and development among multinational enterprises ("MNEs").

1. Basic comparison

Chapter VIII of the Guidelines[1] provides a general framework under which to evaluate Cost Contribution Arrangements ("CCAs") following the arm's-length standard, but does not contain strict rules or requirements with respect to methods of valuation. Similarly, the guidance it provides on how to structure CCAs is limited to broad recommendations—it does not specify particular analytical parameters or provide examples of what an MNE should do.

In contrast, the US Final Temporary Cost Sharing Regulations[2] (the US Regulations) are rules-based and prescriptive, giving the taxpayer a structure within which to set up a Cost Sharing Arrangement (CSA). The US Regulations include specific requirements for valuing the participants' contributions to the CSA.

Despite this basic difference in approach, the same concepts broadly apply under both the Guidelines and the US Regulations. In relation to cost sharing for the purpose of developing intangibles, each participant is entitled to exploit its interest as an effective (economic) owner of any IP. Both systems also require that the overall contribution each participant makes must be consistent with its expected share of the total benefit.

Both the Guidelines and the US Regulations also embody the arm's length principle. This may seem obvious, but it is worth noting that it was recently placed in some jeopardy in the US as a result of the Xillinx case. A decision filed on March 22, 2010, by the US Court of Appeals for the 9th Circuit repealed their original position that the arm's-length standard did not apply and ultimately supported the principle.

Although there is no significant difference from a practical perspective between CSAs and CCAs, experience indicates that there has been relatively limited use of formal CCAs in European tax

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[1] Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.
[2] Treasury Regulations Section 1.482-7T.

jurisdictions in relation to the management and planning of intangible assets. This is certainly due, in part, to the lack of a common set of practical rules that fleshes out the principles in the Guidelines. It is, therefore, useful to develop a deeper understanding of the US Regulations and how these have been applied in practice in order to improve the toolkit available in Europe whilst understanding some of the limitations that arise in a detailed rules-based system.

2. Identification of intangibles

Properly identifying (and understanding) the intangibles that are covered by a cost sharing arrangement is a critical first step. This should include both those that are the subject of future development efforts and those the participants may be contributing at the outset of the arrangement.

The basic difference between the US Regulations and the Guidelines is evident from a comparison of the types of intangibles identified as potentially valuable, as shown in the following tables.

Tables 1 & 2: Intangibles covered in the US Regulations and the Guidelines

US[3]	
• Patent	• License
• Invention	• Contract
• Formula	• Method
• Process	• Program
• Design	• System
• Pattern	• Customer list
• Know-how	• Technical data
• Copyright	• Or any similar item
• Literary	• Workforce (research team)
• Musical	• Research services
• Artistic composition	• Intangibles in process
• Trademark	• Other:
• Trade name	– Resources
• Brand name	– Capabilities
• Franchise	– Rights

OECD[4]
• Patent
• Design
• Model
• Computer software
• Know-how
• Trade secret
• Literary
• Artistic property
• Trademark
• Trade name
• Other marketing intangibles

Simply looking at the two lists highlights some of the differences in relative approach. Both lists include traditional categories of intellectual property that have formal legal protection. The US list also contains further “soft” intangibles, e.g., “Workforce” and “Capabilities,” various types of contractual rights, and the catch-all term “Or any similar item.” However, the US list does not explicitly include goodwill or related terms such as “going concern value” or “business opportunity.”

Both lists present taxpayers with issues and opportunities. The shorter OECD list does not provide as much help to the MNE in understanding the wide array of sources of intangible value, but equally the MNE is not as constrained in determining what may or may not have value. The more comprehensive US list provides the MNE with greater clarity and more definition around what is an intangible, but it also provides less flexibility.

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[3] Internal Revenue Code §936, Preamble to Regulations under §482.
[4] OECD Guidelines, Chap VI, parts A & B.

Not all of these intangibles may be relevant for a cost sharing arrangement. It is useful to consider the question posed at the OECD conference in Paris in September 2009[5] as to whether the Sun is an intangible for a travel agent in a sunny country. Does the Sun pass some common criteria for identifying intangible assets, i.e., is it separable, definable, and controllable by the party in question? Clearly the travel agent does not control the Sun, so we would not simply assign ownership of it to the agent. Alternatively, if the agent's participation in a hypothetical cost sharing arrangement provides the other participants with necessary and beneficial access to this resource and their next best option would be to pay a third party for this access, then there may be an intangible in the hands of the travel agent that relates to the Sun.

This example touches upon some of the difficult economic challenges involved in properly identifying intangibles when creating or evaluating a cost sharing arrangement. A helpful, albeit basic, starting point is to ask whether a party would reasonably expect to be remunerated for an identified intangible and whether another party would reasonably expect to pay for it in an arm's-length negotiation.

3. Valuation of intangibles

Once it has been determined that an intangible is present and should be subject to the cost share, the value must be determined. Although the Guidelines provide limited guidance on the different types of intangibles, they make it clear that the evaluation process must value all contributions made by participants.[6] Likewise, the US Regulations prescribe the valuation of all contributed intangibles and provide more specific guidance on how to undertake that valuation.

If the CCA participants' shares of the overall contributions are found to be out of line with their shares of the overall expected benefits then the Guidelines note that a "balancing payment" between them may be needed. Chapter VII describes "buy-in payments" separately from balancing payments, in the context of the transfer of pre-existing rights from participants to a new entrant into "an already active CCA."[7]

The key underlying task is to value the (intangible) contributions made by one or more of the participants, relative to their shares of expected benefits. However, the Guidelines provide only limited practical guidance on how to value intangibles,[8] leaving practitioners often in the position of appealing to Paragraph 1.68 to employ generally accepted valuation techniques.

The Guidelines do acknowledge that further guidance "may be needed" on measuring the value of contributions to CCAs.[9] The OECD's draft issues notes on the Transfer Pricing Aspects of Business Restructurings released in September 2008 advanced the discussion on some important intangibles issues and usefully provided some additional commercial logic, but it mainly represented a further articulation of principle.

As noted above, the US Regulations include specific instructions for calculating buy-in payments in relation to "Platform Contribution Transactions" (PCTs). Payments in relation to PCT intangibles, as listed in the previous section, in which a participant is treated as having transferred to the other controlled participants in the CSA, may be required in a broad set of circumstances. Despite the range of circumstances, the basic valuation task of determining what the intangible is worth remains the same.

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[5] Transfer Pricing and Treaties in a Changing World, Paris 21-22 September 2009.
[6] OECD Guidelines, para. 8.16.
[7] Ibid., 8.31.
[8] As opposed to the provision of access to them, e.g., under a licence.
[9] OECD Guidelines, para. 8.1.

4. US and OECD: Bringing the analysis together

The OECD methods do not contradict the US approaches. It is therefore a straightforward exercise to link the US Regulation methods to the OECD methods, as in the following table.

Table 3: US Regulations vs. Guidelines: Methods to value IP

US Regulations	OECD equivalent
Market based methods – CUT Method – Acquisition Price Method (APM) – Market Capitalization Method (MCM)	CUP
Income Method – CUT Method – CPM	Income Method (unspecified) – CUP – TNMM
Residual Profit Split Method (RPSM)	PSM
Unspecified methods	Unspecified methods

5. Conclusion

From an economic perspective, the bottom line is that the value of an intangible should be the same, irrespective of which labels or transfer pricing rules are applied—it is the facts of the case that should be the driving factor in the valuation. Though local differences in approach and specific regulations must be taken into account, essentially only one analysis is needed, based on the key economic issues. We anticipate that the EU Joint Transfer Pricing Forum, which is to begin discussing cost sharing in June 2010, will look to the US regulations and experience for guidance.

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