Bloomberg Tax

Tax Management
Transfer Pricing Report™

Reproduced with permission from Tax Management Transfer Pricing Report, 27 Transfer Pricing Report, 8/9/18. Copyright © 2018 by The Bureau of National Affairs, Inc. (800-372-1033) http://www.bna.com

INSIGHT: Transfer Pricing Valuation by Tax Authorities

By Clive Jie-A-Joen, Liu Lu, and Fan Bai

Clive Jie-A-Joen, Liu Lu, and Fan Bai examine recent transfer pricing (TP) developments that are relevant for the arm's-length pricing of transactions of intangibles and other items of value between group entities resulting from business restructuring. The authors conclude that multinational enterprises should take into account the increased focus of tax authorities and international organizations on transfer pricing valuation.

1. Introduction

Multinational enterprises (MNEs) are continuously restructuring their business operations for business reasons (e.g., anticipated synergies, economies of scale, competitive pressure, lowering costs and regulatory developments). Such business restructurings may involve the transfer of functions, risks or assets (e.g., intangibles) within a MNE group. In case something of value (e.g., intangibles and ongoing concern) is transferred, a TP consequence is that the restructured group entity may be entitled to an arm's-length compensation payment. Transfer pricing valuation principles are used to estimate the transfer price for the transfer of something of value between MNE group entities taking into account the arm's-length principle as the valuation standard.

The Organization for Economic Co-operation and Development (OECD) recognized the importance of TP valuation in its base erosion and profit shifting (BEPS) project. The 2015 final OECD report on BEPS Actions 8-10 (Aligning Transfer Pricing Outcomes with Value Creation) provided revised TP guidance on intangibles specifically regarding the use of economic valuation techniques (in particular income-based methods) as one of the OECD recognized TP methods or as a useful tool in estimating the arm's-length price for the transfer of (rights to) intangibles. This revised guidance on intangibles has been incorporated in Chapter VI of the July 2017 version of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines).

The authors' article in the 31 March 2016 issue of this journal discusses the above guidance regarding the application of valuation techniques. The goal of this article is to discuss certain guidance and developments on transfer pricing valuation following the 2015 final OECD report on BEPS Actions 8-10:

On 21 June 2018, the OECD released new guidance for tax administrations on applying the approach to hard-to-value intangibles (HTVI). Under the HTVI approach, tax administrations can consider ex-post outcomes as presumptive evidence regarding the appropriateness of the ex-ante pricing arrangements relating to the transfer of an HTVI. The goal of the new OECD guidance is to arrive at a common understanding between tax administrations regarding how to apply adjustments arising from the application of the HTVI approach. The guidance, which has been incorporated as an annex to Chapter VI of the OECD Guidelines, intends to improve consistency in applying the HTVI approach. It is clear that the HTVI approach will increase the burden of taxpayers to substantiate the pricing of HTVI transactions.

Further to that, the EU joint transfer pricing forum released the draft report on the use of economic valuation techniques in transfer pricing on 22 June 2017 (EU Draft Report). The report is intended to build a bridge between the general practice of economic valuation and transfer pricing. The report highlights that when using economic valuation technique for TP purposes, the OECD Guidelines should be taken into account and the valuation techniques should be adjusted accordingly. The EU Draft Report should be considered when doing TP valuations involving an EU country.

COPYRIGHT © 2018 BY THE BUREAU OF NATIONAL AFFAIRS, INC.

The second edition of the United Nations Practical Manual on Transfer Pricing for Developing Countries (TP Manual) was released on April 7, 2017. It contains a new chapter on the treatment of intangibles. The revised TP Manual considers the results of the OECD BEPS project.

A new Dutch transfer pricing decree, which was published on 11 May 2018 in the Government Gazette, sets out important aspects of the Dutch Tax Administration's interpretation of the arm's length principle, including on transfers of intangibles.

There are pending EC state aid cases and U.S. Tax Court cases on the pricing of inter-company licensing of intangibles.

Developments involving transfer pricing valuation in tax courts include:

- (a) Dutch court case dealing with the TP consequences of business restructuring within an MNE group (Court of Zeeland—West Brabant, 19 September 2017, number BRE 15/5683). The main question was whether the compensation payment received by the taxpayer for the termination of the cooperation agreement was at arm's-length. The court case shows that meeting TP documentation supporting the arm's-length nature of transfer prices is important so that there is no automatic reversal of burden of proof to the taxpayer. The case also highlights the importance of assessing when business restructuring actually happens which requires dealing with the TP consequences.
- (b) AMAZON.COM, INC. & SUBSIDIARIES, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent, Docket No. 31197-12, 148 T.C. No. 8. In this case, the United States Tax Court ruled (March 23, 2017 filing) that the Commissioner of Internal Revenue's determination of buy-in payment with respect to the intra-group licensing of website technology, marketing intangibles and customer lists relating to European clientele by Amazon Inc. to a Luxembourg Amazon group entity is arbitrary, capricious, and unreasonable. It determined that the comparable uncontrolled transaction method with appropriate upward adjustments is the best TP method to determine an arm's-length cost sharing buy-in payment.
- (c) On December 18, 2017, the European Commission announced that it has opened an investigation into two tax rulings granted by the Dutch Tax Administration to Inter Ikea Systems on its franchise fee structure. One of the rulings involves the endorsement of the acquisition price for the inter-company transfer of intellectual property.

These developments show the increased focus on TP valuation by tax authorities and international organizations. We will also provide some comments on the impact of the U.S. Tax Cuts and Jobs Act, which was signed into U.S. law on 22 December 2017, on valuations. Each of these developments is specific and useful considering the specific facts and circumstances of the case at hand.

2. New OECD Guidance to Tax Administrations on Applying the HTVI Approach

The new OECD guidance of 21 June 2018 provides guidance to tax administrations on applying the HTVI approach with the purpose of improving consistency and reducing double taxation risk. The HTVI approach may result in transfer pricing adjustments by tax administrations. The new OECD guidance discusses (a) the principles underlying the application of the HTVI approach, (b) examples illustrating the practical application of the HTVI approach, and (c) the interaction between the HTVI approach and access to the mutual agreement procedure. The HTVI approach and the practical application guidance are particularly relevant for taxpayers that have been engaged in or are involved in the transfer of intangibles with other MNE group members.

What is the HTVI Approach? The HTVI approach has been adopted as guidance in the revised 2017 OECD Guidelines and provides tax administrations with a tool to evaluate the pricing of inter-company transfer or licensing of intangibles.

A HTVI includes intangibles or rights in intangibles for which at the time of their transfer between group entities (a) no reliable comparables exist, and (b) the projections of future cash flows attributable to the transferred intangible or the assumptions used in valuing the intangible are highly uncertain. Examples of an HTVI include an intangible that is partially developed at the time of the transfer or an intangible that is used or developed under a cost contribution arrangement.

According to Chapter VI of the OECD Guidelines, information asymmetry faced by tax administrations in connection with assessing which developments or events are relevant for pricing a transfer of rights in HTVI intangibles and the extent to which the direction of such developments or events might have been foreseen at the time of the transaction, will increase the difficulties faced by tax administrations in evaluating the arm's- length nature of pricing the transfer of HTVI.

Under the HTVI approach, tax administrations can consider ex-post outcomes as presumptive evidence about the appropriateness of the ex-ante pricing arrangements used in inter-company transfers or licensing of HTVI at the time of the transaction, in order to protect tax administrations from the negative impact of information asymmetry. Differences between ex-ante projections and ex-post results not resulting from unforeseeable developments or events may indicate that the pricing arrangement agreed upon at the time of the transfer does not reflect the arm's-length principle. Ex-post outcomes, which are not dependent on assumptions used by taxpayers, can provide information to tax administrations.

The HTVI approach will not apply under certain exemptions:

- The taxpayer can rebut the presumptive evidence by demonstrating the reliability of the information used at the time of the transfer;
- The difference between financial projections and actual outcomes does not lead to a valuation discrepancy of more than 20 percent as compared to the original valuation;
- A bilateral or multilateral advance pricing arrangement is in place for the HTVI transfer; or
- Five years have passed after the year in which the HTVI first generated third party revenues and the difference between financial projections and actual outcomes did not exceed 20 percent in this period.

Considering that HTVI are hard to value, the authors believe that the 20 percent threshold is too low.

COPYRIGHT © 2018 BY THE BUREAU OF NATIONAL AFFAIRS, INC.

Corresponding with U.S. Approach? The OECD Guidelines provide that the HTVI approach is not using hindsight in which ex post results are taken for tax assessment purposes without considering whether the ex post results are based on events or developments that were known or reasonably foreseeable at the time of the HTVI transfer. However, the authors note that the HTVI approach essentially corresponds to the U.S. 'commensurate with income' approach embedded in the general U.S. transfer pricing regulations in Section 1.482-4(f)(2) on periodic adjustments. Under this approach, if an intangible is transferred based on an agreement with a term of more than one year, the consideration in each year may be adjusted so that the consideration is commensurate with the income attributable to the intangible. The U.S. regulations have several exceptions to this approach, including a comparable uncontrolled transaction exception, an extraordinary events exception, and an exception incorporating that the total actual profits earned or cost savings realized by the controlled transferee from exploiting the intangible in the year under examination and all past years are not less than 80% nor more than 120% of the projected profits or cost savings foreseeable at the time of entering into the related party agreement. There are also periodic adjustments provisions in Section 1.482-7 regulations on cost sharing arrangements. The authors are of the view that the OECD guidance on HTVI approach ought to be aligned in terms of all the exceptions set forth in U.S. 1.482-4 and 1.482-7 regulations to limit the potential for double taxation.

What are the Principles Underlying the Application of the HTVI Approach The principles underlying the application of the HTVI approach include:

- Tax administrations can consider ex-post outcomes as presumptive evidence on the reasonableness of the assumptions of the ex-ante pricing arrangements;
- The ex-post outcomes should inform the determination of the valuation that would have been made at the time of the HTVI transfer. However, it is inappropriate that the valuation is based on the actual income or cash flows without considering whether the associated enterprises could reasonably have known the information in connection with the probability of achieving such ex-post results at the time of the HTVI transfer;
- In case an amended valuation demonstrates that the HTVI was transferred at a value below or above the arm's length price, the amended price may be assessed to tax considering price adjustment clauses and contingent payments notwithstanding the pricing structure alleged by the taxpayer;
- Audit practices should be applied by tax administrations as soon as possible to identify presumptive evidence based on ex-post outcomes.

What Objective Evidence Should Taxpayers Present? The HTVI approach will increase the burden of taxpayers to substantiate the pricing of HTVI transactions. Among the questions that may arise under the HTVI approach: what objective evidence should be presented by taxpayers present to demonstrate that its original valuation properly considered all developments or events at the time of the HTVI transaction and, when developments or events occur that were not considered, that these were unforeseeable developments or events?

The lack of clarity as to what is required for a taxpayer to demonstrate will result in uncertainty and economic double taxation. Clear OECD guidance addressing this issue is necessary. For example, in case financial projections have been prepared for business planning purposes (e.g., to obtain a loan from a bank or used by management to make business and investment decisions), this could indicate that these projections are the most reliable projections at the time of HTVI transfer.

What Audit Practices? Timing issues are important to consider under the HTVI approach. The new OECD guidance provides that tax administrations should apply audit practices to identify and deal with HTVI transactions as early as possible. It is recognized that only after some years after the HTVI transfer tax administrations may be able to consider whether the HTVI transfer is priced at arm's-length. In addition, the elapsed time between the HTVI transfer and the availability of ex-post outcomes may not always correspond with audit cycles or with administrative and statutory time periods, especially for HTVI that will be commercially exploited only long after the transfer.

The new OECD guidance suggests that countries are not required to adopt legislation to overcome difficulties in implementing the HTVI approach resulting from, for example, short audit cycles or short statute of limitations, but that countries may consider changes to procedures or legislation. In this respect, the new OECD guidance refers to the introduction of a requirement to notify promptly the transfer or license of an HTVI, or amendment of the normal statute of limitations.

The authors note that any notification or disclosure obligation should be accompanied by a clear set of rules for taxpayers to be aware exactly when a notification must be made. The broad description of the term HTVI is unsuitable in this respect. Once a notification is made, tax administrations should commit to efficiently and on-time review and communicate with taxpayers in case they have potential concerns about the HTVI transfer.

More Balanced Examples Needed to Illustrate the Practical Implementation of Applying the HTVI Guidance The new OECD guidance describes three examples (Example 1 consists of Scenario A and Scenario B and Example 2) illustrating the practical application of a transfer pricing adjustment arising from applying the HTVI approach. For example, Example 1, Scenario A, illustrates a case in which a taxpayer cannot demonstrate that its original valuation properly considered the possibility that commercialization would start earlier, and cannot demonstrate that such a development was unforeseeable. Hence, the tax administration is allowed to make an adjustment to assess additional profits in accordance with the HTVI approach.

Example 1, Scenario B, illustrates the application of the 20% valuation discrepancy exemption so that the application of the HTVI approach is prevented, while Example 2 illustrates a case in which sales were significantly higher than those projected.

The authors note that all the examples result in an upward adjustment or no adjustment (because an exemption is applicable) to assess additional profits. In practice actual sales could be lower than projected sales, or commercialization in fact started later than envisaged at the time of the HTVI transfer. This means that financial projections may have been too optimistic. Hence, the OECD should clarify that valuations can be

COPYRIGHT © 2018 BY THE BUREAU OF NATIONAL AFFAIRS, INC.

revised both upwards and downwards to account for uncertainties.

HTVI and the Mutual Agreement Procedure (MAP) The new OECD guidance encourages countries to resolve double taxation cases under the MAP in the relevant treaty. The authors believe that double taxation risk is considerable, despite efforts to improve the effectiveness of MAP. Under the MAP process, countries shall endeavor, without any legal commitment, to resolve double taxation cases. Further, not all countries that may adopt the HTVI approach have committed to the mandatory binding arbitration process proposed under BEPS Action Plan 14 (″Making Dispute Resolution Mechanisms More Effective″). In this regard, the OECD's continuing effort to encourage countries to improve their MAP process is essential. appreciated, through raising awareness, education, peer reviews and by encouraging countries to adopt binding arbitration.

3. EU Joint Transfer Pricing Forum Draft Report on the Use of Economic Valuation Techniques

In an effort to build a bridge between the general practice of economic valuation and transfer pricing, the EU Draft Report explains in more details: (1) the choice of an appropriate economic valuation technique, (2) key parameters, and (3) differences between TP valuations and general valuations. The goal is to provide recommendations on how valuation techniques can be practically and more efficiently used in the European Union (EU) for TP purposes.

The EU Draft Report does stress that the application of valuation techniques in a TP analysis should consider the arm's-length principle and the principles described in the OECD Guidelines. This should be documented in accordance with generally applicable national rules and common international and EU practices.

The EU Draft Report suggests that because several economic valuation techniques make use of transfer pricing sensitive inputs (e.g. cash flows), it is recommended to ensure that there is consistency between economic valuation techniques and the method used to determine transfer prices.

3.1 Economic Valuation Techniques and Standards Similar to the OECD Guidelines, the EU Draft Report focuses on the income-based approach, which assumes that the value of a business or asset is equal to the present value of the projected future benefits (earnings or cash flows). It states that the market-approach and cost-approach may be relevant in certain circumstances.

The three valuation approaches and the various valuation methods under each approach are:

The Income-based Approach

The income-based approach assumes that the value of a business or asset is equal to the present value of the projected future benefits (earnings or cash flows). Under this approach there are various methods that can be used to determine the cash flows or earnings attributable to the specific business or asset:

- Relief-from-royalty method—the value of an intangible is determined by considering that without owning the subject intangible, the user would have to make a stream of payments to the intangible owner in order to use that intangible;
- Premium profit method—the forecasted profits or cash flows that would be earned by a business using the intangible (this business may ask a premium price or realize cost savings as a result of this intangible) are compared with the forecasted profits or cash flows that would be earned by a business without the intangible;
- Residual value method—
- o Excess earnings method (adjusted for contributory assets returns): the value of an intangible is equal to the present value of the incremental cash flows (i.e. excess earnings) attributable to the intangible after deducting for contributory asset charges (for all other assets)
- o Residual value method (adjusted for routine returns): the value of an intangible is equal to the present value of the incremental cash flows (i.e. residual value) attributable to the intangible after deducting for routine returns to account for cash flows from routine activities; and
- Incremental cash flow method: the value of an intangible is equal to the present value of the cash flows directly attributable to the intangible.

Market-approach

Observable market-based transactions of identical or substantially similar intangibles or enterprises (business units) have to be identified:

- Acquisition price method—the value of an intangible is determined based on the price paid for acquiring a third party company;
- Market capitalization method—the value of an intangible is determined by reference to the market capitalization of the company; and
- Comparable multiples—analyzes market multiples (e.g., enterprise value to EBIT or enterprise value to EBITDA) of comparable peer group companies to estimate value of subject business.

Cost-approach

The cost-based approach connects a value of an individual asset with a measure of its cost. It is based on the ''economic principle of substitution and does not consider the amount, timing, and duration of future economic benefits:

- Historical cost method: the value of an intangible is based on the capitalization of historical costs incurred for developing the subject intangible; and
- Replacement cost method: the value of an intangible is based on accumulating the costs that would currently be required to recreate the functionality of the subject intangible

The EU Draft Report notes that the actual use and selection of the economic valuation technique should consider the following aspects:

- The characteristics of potential valuation techniques and the appropriateness of the techniques in view of the facts and circumstances of the transaction under review;
- The availability of reliable information required in order to appropriately apply the technique;
- Whether the complexity and the compliance burden associated with applying the technique and obtaining the relevant information is proportionate to the transaction under review;
- Conducting an analysis under more than one valuation technique is not required; and
- Consider performing a sensitivity analysis or sanity check.

COPYRIGHT © 2018 BY THE BUREAU OF NATIONAL AFFAIRS, INC.

3.2 Key Parameters for Economic Valuation Techniques The EU Draft Report provides that from a content perspective, the economic valuation techniques are homogeneous in the EU and in some leading third countries, as they are built on some common parameters, including financial projections on cash flows (including growth rates), royalty rates, routine returns, useful life of intangible and terminal values. In certain situations the application of economic valuation techniques are based on assumptions regarding transfer prices. For example, the relief-from-royalty method depends on the estimation of royalty rates. TP methods can be used to determine arm's- length royalty rates from a transfer pricing perspective. The key take-aways of the EU Draft report on the main valuation parameters are:

Financial Projections and Growth Rates

- Preferably use projections made for non-tax purposes e.g., management accounts, forecast for external financing;
- Recommendation: A reviewer should be provided with the data on which the financial projection is based, if available (e.g., management accounts and information supporting the assumptions made (inter alia growth rates, the exploitation scenario assumed and the link between the valuation object and the projected cash flows); and
- The deduction of taxes in cash flows should be reflected in the capitalization rate. From the perspective of the buyer and seller the tax amortization benefit respectively the exit tax should be determined.

Royalty Rate to be Considered in the Relief from Royalty Method

- The application of certain valuation techniques require the determination of a royalty rate. From a transfer pricing perspective, the arm's length principle and the OECD TP Guidelines (in particular Chapter VI on intangibles) should be considered in determining this royalty rate; and
- Such a royalty rate can be determined through internal sources of information (internal comparables) and external sources of information (e.g., conduct benchmarking study using databases to identify comparable agreements between independent enterprises). Reference is made to databases, such as Royaltystat, Royaltysource, KTMINE, TP Catalyst and Lexis Nexis.

Routine Returns

The application of certain valuation techniques require the determination of routine returns. The routine returns should be determined consistent with the arm's length principle and the OECD TP Guidelines.

Discount Rate

There should be consistency between how the cash-flow is derived and which measure of discount rate is used. For example, the discount rate should reflect both the cost of equity and cost of debt if the cash-flow relate to both equity holders and bond holders. The weighted average cost of capital (WACC) would then constitute an appropriate discount rate;

Recommendation: It should be demonstrated how the discount rate was calculated, why the calculation is appropriate and whichinformation was used to calculate the discount rate.

Useful Life

- Evaluate the useful life from the perspective of the transferor and the transferee in the case of two-sided valuation; and
- There are internal sources (e.g., information on the planned use of the acquired IP by the buyer) and external sources (industry practices, external studies and economic literature) of information for estimating the useful life.

The EU Draft Report provides that two-sided valuation (i.e. from the perspectives of the transferor and transferee) may result in a range rather than a specific price. The arm's-length price will fall within such a range. An analysis of all the facts and circumstances at the time of the transaction including the bargaining power of the parties should be conducted in order to decide which specific value within the range should be selected. It is suggested that the mid-point may serve as a fall-back position when it is not possible to demonstrate that another point is more appropriate.

3.3 Differences Between Valuation for Transfer Pricing Purposes and General Valuation Valuations may be prepared for non-TP purposes, including external financial reporting requirements, mergers & acquisitions and contractual agreements. When used in a TP context, the EU Draft Report recommends that these valuations and underlying assumptions should be checked whether consistent with the transfer pricing analysis under review (including the arm's-length principle and the principles of the OECD Guidelines). In particular, the following two issues should be considered:

Is the valuation object sufficiently comparable to the valuation object of the transfer pricing analysis? The EU Draft Report especially emphasized that comparability aspects should include the assets involved, the businesses functions performed (by the legal entity and other group entities) as well as the perspective from which the valuation was conducted (i.e. for which entity).

Are the assumptions and technical aspects taken into account in the existing valuation consistent with the facts and circumstances of the transfer pricing analysis under review, for example:

- Are cash flow projections, risk levels, discount rate, useful life and valuation date comparable?
- Could the stakeholders' interest in the existing valuation have affected the valuation?
- What level of objective support has been provided regarding the valuation inputs in existing valuation? How can the valuation inputs be objectivized?

In case a valuation conducted for non-TP purposes is used in a TP context, it should be documented whether it is consistent with the arm's-length principle and the principles of the OECD Guidelines.

4. Revised UN TP Manual

The revised UN TP Manual considers feedback received on the first edition (2013) and the outcome of the OECD BEPS project. It contains a new Chapter B.5 that focusses on the TP considerations for intangible property. This new chapter includes a section on the selection of the most appropriate TP method and a section on supplementary guidance for applying methods.

4.1 Selection of the Most Appropriate Transfer Pricing Method The new Chapter B.5 provides that the selection of the most appropriate method depends on the type of intangible transaction. With respect to transac-

COPYRIGHT © 2018 BY THE BUREAU OF NATIONAL AFFAIRS, INC.

tions involving the sales of intangibles, the CUP method (including the acquisition price method which is a specific application of the CUP method) and the discounted cash flow (DCF) method may be appropriate methods.

4.2 Supplemental Guidance for Applying Methods

The UN TP Manual's supplemental guidance for applying methods for intra-group transfers of intangibles is generally consistent with the OECD Guidelines.

The similarities with the OECD guidelines and certain additional guidance provided by the UN TP Manual are as follows:

Acquisition Price Method

Similarities with OECD Guidelines: The UN TP Manual provides that in case of an intra-group transfer of intangibles whereby the intangibles were part of an acquisition from a third party, the price paid for the acquisition of the third party company may constitute a relevant starting point for determining an arm's-length price for the intra-group transfer of intangibles.

Additional UN Guidance: This application of the CUP method is sometimes also called the acquisition price method. The OECD Guidelines do not specifically refer to the acquisition price method.

Cost Based Method

Similarities with OECD Guidelines: Cost based method (based on cost of development) is generally discouraged to value the transfer of intangibles.

Valuation Techniques

Similarities with OECD Guidelines: Valuation techniques may be used as a part of one of the TP methods or as a useful tool in determining an arm's-length price for the intra-group transfer of intangibles in case reliable comparable uncontrolled transactions cannot be identified. These valuation techniques include in particular the calculation of the discounted value of projected future income streams or discounted cash flows derived from exploiting the intangible.

Additional UN Guidance:

- The UN TP Manual suggests that corporate finance textbooks provide a fairly solid grounding of DCF methods.

- The UN TP Manual discusses the circumstances in which a DCF approach might be appropriate:

- o As a DCF calculation is forward looking it is in general conducted on an ex-ante basis rather than on an ex-post basis.

- o A DCF analysis may be conducted after the intangible transfer to inform the analysis of the value of the intangible at the time of transfer. However, the reliability of this analysis may be reduced.

DCF Method

Similarities with OECD Guidelines: Guidance is provided with respect to the valuation parameters in applying the DCF method, including financial projections, discount rate, useful life, growth rates, and the tax effects of the transaction.

Additional UN Guidance:

- Financial projections should reflect the best estimates of items projected, including sales, development costs, costs of sales, and operating expenses.

- In addition, it is possible to base financial projections on a probability-weighted average of possible outcomes because of the uncertainty in possible outcomes. An example is provided containing an optimistic outcome, an expected outcome and a pessimistic outcome.

- A technical note is provided on how to calculate the terminal value.

- The UN TP Manual does not refer to the WACC to estimate the discount rate.

Present Value

It is necessary to consider the present value calculated from the perspective of both parties to the controlled transactions.

Options Realistically Available

Similarities with OECD Guidelines: An example is provided in the UN TP Manual to illustrate the concept of options realistically available. Under the UN TP manual example, a group company A has to option to sell the entire rights to the genetically modified seeds to group company B prior to starting the R&D project. The example illustrates that company A would not surrender the intangible rights for an amount less than the alternative option of retaining the rights to the intangible itself and exploiting it in country B.

Additional UN Guidance: In the example, pre-tax cash flows are discounted against a post-tax WACC. The UN TP Manual provides that this simplifying assumption is generally not appropriate, because post-tax discount rate is normally used to discount post-tax income streams. However, it may be appropriate in certain circumstances.

Accounting Purposes

Caution should be exercised in accepting valuations conducted for accounting purposes to reflect arm's length prices for transfer pricing purposes.

Ex-post and Ex-ante Outcomes

Similarities with OECD Guidelines: There are situations in which ex-post outcomes can provide a pointer to tax administrations as to the arm's-length nature of the ex-ante pricing arrangements. In this respect, the UN TP Manual provides that the conclusions of Section D.4 of Chapter VI of the OECD TP Guidelines (paragraphs 6.186-6.195) on hard-to-value intangibles are considered valid in the context of the UN TP Manual.

Additional UN Guidance: The UN TP Manual provides that a DCF analysis is conducted on an ex-ante basis, while tax audits normally take place at a later time. However, information on ex-post results will allow tax administrations (acknowledging discrepancy between anticipated results and actual results) to ask questions, including the following questions, to determine whether the ex-ante analysis of the taxpayer truly reflected an appropriate determination of anticipated profitability and risk associated with the intangible:

- How do the actual results differ from the anticipated results? Are the actual results within or outside the anticipated range of potential results? What explains the divergence?
- What is the company's track record with respect to other relevant capital budgeting decisions?
- On what basis was the initial risk assessment undertaken, both regarding the probability-weighted financial projections and the estimation of the discount rate?
- Is the discrepancy between anticipated results and actual results likely to continue going forward?
- Have there been unanticipated events following the initial transaction which explain the discrepancy to

COPYRIGHT © 2018 BY THE BUREAU OF NATIONAL AFFAIRS, INC.

some extent?
The UN TP Manual stresses that it is generally inappropriate for a taxpayer or tax authority to perform a DCF analysis based on ex-post results to assess the ex-ante value of an intangible. Such a DCF analysis using ex-post data may be regarded an inappropriate use of hindsight.

Contingent Base

The UN TP Manual suggests that a DCF can be used to determine on an ex-ante basis an arm's-length contingent payment (e.g., royalty on anticipated sales), which is then applied to the actual contingent base (e.g., the same royalty rate on actual sales).

5. New Dutch Transfer Pricing Decree

On 11 May 2018, a new Dutch TP decree was published in the Government Gazette (no. 26874) which replaces and updates the earlier decree of 14 November 2013 to take into account recent TP developments, including the revised July 2017 OECD TP Guidelines. The decree is binding to the Dutch tax administration (DTA) and presents its position with respect to certain TP issues where the OECD Guidelines leave room for interpretation or where there is ambiguity. The article of Clive Jie-A-Joen and Monique van Herksen in the 31 May 2018 issue of this journal discusses the decree in more detail.

The Dutch TP decree discusses various topics relevant for the valuation of inter-company transfer or licensing of intangibles, including:

In determining an arm's-length price for the transfer or licensing of an intangible, valuation methods, and in particular the discounted cash flow method, can be used by taxpayers and by the DTA as part of the five recognized OECD TP methods or as a valuation method.

The tax consequences of the transfer of an intangible should be considered in case of an asset transaction:

- The seller would like to be compensated for the possibility that the fiscal book gain resulting from the transfer of the (intangible) asset is taxable; and
- The buyer should consider the possible tax amortization benefits of the acquired (intangible) asset.

Price adjustment clause: it is not arm's-length to agree on a fixed price for the transfer of an intangible if the valuation at the time of the transaction is highly uncertain and economically rational acting independent parties would not agree on a fixed price in a similar situation. In such cases, for example, an adjustment clause (that can lead to both an upward and downward adjustment of the originally agreed price) should be included in the agreement between the associated enterprises where the price is partly dependent on future income.

Hard-to-value intangible: The Netherlands implements the HTVI approach in the decree. In case a HTVI is transferred or licensed between group companies, the DTA can use the actual results (i.e. profit or loss) obtained from exploiting the relevant intangible in assessing the arm's-length price at the time the transaction occurred. If there is a major deviation between the realized results (i.e. profit or loss) and the expectations (and resulting prognosis) that formed the basis for the determination of the price of the HTVI at the moment of the license or transfer and this deviation cannot be explained on the basis of facts and circumstances occurring after the date of the price determination, the DTA can question the price as determined at the time of the transaction with a reference to the actually realized results. A large deviation is defined as a deviation of more than 20% as compared to the projections that formed the basis for the original price.

Acquiring shares in an unrelated company followed by a business restructuring: In case an MNE acquires shares of an unrelated company and subsequently transfer the intangibles held by the unrelated company to another group company, the following transfer pricing issues should be considered:

- It is important to determine whether, in addition to the legal ownership of the intangibles, the associated functionality and the related risks are transferred as well;
- The arm's-length price for the shares of the acquired company is considered to contain useful information for the valuation of the business of the company. Hence, the acquisition file (with the exception of those elements which can be substantiated by taxpayers that they are not relevant to taxation), is an essential part of the TP documentation of the taxpayer to substantiate the price for the transferred intangibles;
- The value attributed to the intangible assets in the acquired company based presumably on a purchase price allocation study may provide a good indication of the minimum price that the buyer of the shares would like to obtain when transferring these assets following the acquisition of the unrelated company;
- The related seller of the intangible should consider that corporate income tax may need to be paid on the achieved book profit on the asset transfer;
- In cases where the entrepreneurial positions and associated intangible assets of an acquired company are transferred to another group company and only the routine functions are left behind in the acquired company, the DTA will generally assume that the expected cash flow of a routine function cannot be discounted based on infinite useful life, because such functions can be replaced relatively easily in the market and contracts relating to such functions are therefore usually relatively short-term.

Determining the remuneration for using an intangible:

- **External CUP:** The DTA will critically evaluate the use of databases that identify royalty percentages, because it questions whether the publicly available information available in these databases is sufficiently detailed to conduct a robust comparability analysis.
- **Resale price method, cost-plus method and the TNMM:** under certain conditions, in the absence of comparable uncontrolled transactions, it is acceptable to apply these one-sided methods to determine the amount of the fee to be paid by the tested party (conducting the less complex functions) for the use of an intangible. The application of these TP methods results in residual profit that can be attributed to the intangibles by first determining the remuneration for the tested party. This residual profit constitutes the remuneration for using the intangible and the related functions performed.

COPYRIGHT © 2018 BY THE BUREAU OF NATIONAL AFFAIRS, INC.

6. State Aid Cases and U.S. Tax Court Cases on the Pricing of Inter-company Licensing Transactions

One-sided TP methods, in particular the TNMM, are often applied in practice to determine the pricing of inter-company licensing of intangibles. Under the European Commission (EC) state aid cases of both Starbucks Manufacturing EMEA BV (SMEBV) and Amazon EU Sàrl, the TNMM was basically applied in the tax rulings granted to these companies on the related party licensee to determine the remuneration of the related party licensee. The residual profit earned by the related party licensee (exceeding the TNMM remuneration) constitute the remuneration for licensing the intangibles. Hence, the TNMM was used to indirectly determine the royalty to be paid for the inter-company licensing of intangibles by SMEBV to Alki and by Amazon EU Sàrl to Amazon Europe Holding Technologies. In its final decision of these two cases, the EC disagreed with using the TNMM and / or its application and concluded that selective tax advantages were granted to these companies through the tax rulings, and hence that these tax rulings are not in line with EU state aid rules. In the final decision of SMEBV, the EC disagreed with characterizing SMEBV as a toll manufacturer and suggest that the comparable uncontrolled price method is applicable. In the final decision of Amazon EU Sàrl, the EC conducted a detailed functional analysis (including an analysis of the Development, Enhancement, Maintenance, Protection and Exploitation functions) and argued that the TNMM should be applied on Amazon Europe Holding Technologies rather than on Amazon Europe Sàrl, the operational company. In both EU state aid cases, the functional analysis was important in substantiating the choice and application of the most appropriate TP method.

At issue under the U.S. tax court case of Medtronic Inc (June 9, 2016) was royalties paid by Medtronic Puerto Rico to Medtronic US for licensing technology and know-how to manufacture medical devices and leads in 2005 and 2006. In addition, Medtronics Puerto Rico also engaged in the following inter-company transactions: (a) licensing of trademark from Medtronic US, (b) purchase of components from Medtronic US, and (c) sale of finished products to Med USA. The IRS regarded Medtronics Puerto Rico as an assembler of components / contract manufacturer and argued that the aggregate comparable profits method (CPM) was the best TP method (to be applied on Medtronics Puerto Rico) for analyzing the inter-company transactions. The tax court rejected the IRS' use of the CPM (the US TNMM), because it disagreed with the IRS amongst others on the characterization of Medtronics Puerto Rico as a mere assembler of components / contract manufacturer. In its view Medtronics Puerto Rico is an FDA regulated manufacturer of medical devices responsible for the important quality control function, and contributed to the design process and product development. The tax court applied an adjusted internal comparable uncontrolled transaction method (the US CUP method for intangibles) with various comparability adjustments made on one internal comparable uncontrolled transaction. The IRS has appealed the case to the Eight Circuit.

Under the ongoing U.S. tax court case of The Coca-Cola Company (TCCC), the IRS alleges that related party licensees were undercharged by TCCC by USD 9.4 billion for the licensing of beverage trademarks and formulas for the 2007-2009 period. The IRS arrived at this amount based on applying the CPM on the foreign licensees. The IRS regards the licensees as limited risk manufacturers of concentrates. The taxpayer argues that TCCC is a decentralized MNE and that the foreign licensees are responsible for developing the markets in their region and the relationships with the unrelated bottlers to whom the manufactured concentrates are sold.

Under the above two U.S. tax court cases, the facts and circumstances, including the functional analysis, are important in substantiating the choice and application of the TP method.

7. Recent Court Cases on Transfer Pricing Valuation

This section describes three recent TP valuation cases. However, there are other controversy cases, such as the 2014 Swedish court case on intra-group sale of a trademark by a Swedish group company.

7.1 Dutch Court Case on Business Restructuring This court case (court of Zeeland - West Brabant, 19 September 2017, number BRE 15/5683) deals with the following TP consequences of business restructuring within an MNE group: (a) the potential compensation payment, if any, to be paid to the restructured group entity for the transfer of functions, risks and / or assets, and (b) the TP policy regarding the post-restructuring transactions.

The case regards a Dutch taxpayer (hereinafter called ''X'' or ''taxpayer'') that has been part of a MNE group for many years. Its operational activities consist of the processing of zinc concentrate and related raw materials. Prior to 2003, X performed all the necessary functions in the total value chain of zinc smelting as owner of the assets and assuming business risks. Since 2003, X was subject to several business restructuring activities:

X gradually transfered activities other than the actual production activities to a global organizational structure, the so-called Global Marketing & Services team (GMS). As a result, economies of scale benefits were achieved in the area of purchasing, sales, and deployment of personnel.

Under a 2009 business restructuring, a Belgian group entity B was established. B provided support services to the smelters (through GMS) and managed and administered the purchase of all raw materials and the sale of all products and by-products. Under a Business Transfer Agreement, B purchased the working capital of the various related smelting companies (including X). In addition, B concluded a Cooperation Agreement with the smelting companies (including X) with a term of two years in which B supplies the raw materials to the smelting companies. The smelting companies would process the raw materials and provide the end products to B. The Belgian group entity was entitled to a remuneration based on its costs with a mark-up of 7.5 percent and a 3.487 percent return on its equity. A so-called ''EBIT passback'' clause ensured that the results related to the commercial process of purchasing and selling were allocated back to the smelting companies.

COPYRIGHT © 2018 BY THE BUREAU OF NATIONAL AFFAIRS, INC.

Effective 1 July 2010, the MNE group decided to move its head office from London and Brussels to Zürich, Switzerland (about 100 employees). In the new structure, the management of production planning, purchasing, logistics, and sales is centralized at A AG in Zürich in order not to expose the smelting companies to related financial risks. The Cooperation Agreement with X was terminated for which X received a compensation payment of €28,351,364. Under a Manufacturing Services Agreement, the smelting companies are remunerated based on the cost price of the smelting activities plus a mark-up of 10 percent.

The tax inspector increased the taxable amount from €32,067,270 to €188,342,906 in X's FY 2010 corporate income tax return. According to him, the compensation payment should amount to €184,627,000 rather than €28,351,364, because in his view the taxpayer still performs the main core functions even after moving the head office to Switzerland, which should be considered in calculating the compensation payment.

Pursuant to the Dutch Corporate Income Tax Act, a taxpayer is required to have sufficient TP documentation in its administration to substantiate the applied transfer prices. In this respect, the judge ruled that the taxpayer did meet its administrative and documentation requirements, because it prepared several reports to evaluate the compensation payment. In addition, the taxpayer has also adequately substantiated the net cost plus method used to remunerate its toll manufacturing function. A potential consequence of not satisfying these requirements is a reversal of the burden of proof to the taxpayer. Even if taxpayer had not satisfied the documentation requirements, however, the Court noted that the burden of proof would not have been reversed to taxpayer, since the tax inspector did not provide an information ordinance determining defects in the taxpayer's administration.

The tax inspector provided the following comments on the compensation payment calculated by X:

- The taxpayer assumes merely the termination of the Cooperation Agreement. The inspector argues that the calculation should consider the profits and costs of activities such as purchasing and selling;
- Taxpayer unfairly assumes an expected loss of income for the period of one year, which is the remaining term of the Cooperation Agreement;
- The compensation payment calculated by the taxpayer is lower than past actual annual profits. X incorrectly assumes that the activities of GMS were not conducted for the account and risk of X; and
- Taxpayer made a calculation mistake of €50 million and the cash flows in a real sense have been discounted against a nominal discount factor.

The court considers it plausible that X already gradually transferred the activities that are involved with the purchase, sale, and logistics in the years prior to 2010 to other group entities. According to the Court, the transfer of these activities started with entering into the GMS. In determining the compensation payment, it is therefore not necessary to consider amongst others the buying and selling activities that are not conducted anymore by X. In a business restructuring case, a key question is indeed when restructuring occurred which requires compensation payment and a change in TP policy for the post-restructuring transactions. In subject case, the tax inspector did not litigate fiscal years prior to 2010.

The taxpayer further stated that during the negotiation of the compensation payment, consideration was given to its bargaining position and possibilities to request compensation for a larger period of time than the last year of the Cooperation Agreement. The taxpayer thus argues that it has considered the possibilities of compensation for terminating the Cooperation Agreement as well as the compensation for future expectations. According to taxpayer, it appeared that compensation, due to the poor prospects, was not on the agenda. Although large investments were made in the past in the smelter, these investments mainly relate to an adjustment of the production process to the environmental standards at the time. The smelter of X is otherwise not so distinctive from other smelting plants that it would justify a higher compensation payment.

Regarding X's remuneration for its toll manufacturing activities, the Court is of the view that X can be regarded as a toll manufacturing company, and therefore the net cost plus method is an acceptable method to determine an arm's-length remuneration for X.

The Court thus ruled that the inspector did not comply with the burden of proof regarding his position that X did not apply arm's-length transfer prices. The tax inspector has appealed the Court's decision.

7.2 U.S. Tax Court Case on Valuation of Cost Sharing Buy-in Payment Pursuant to a cost sharing arrangement entered into in 2005, Amazon US granted Amazon Europe Holding Technologies SCS (AEHT), a Luxembourg subsidiary, the right to use the following pre-existing intangibles in Europe: (1) software and other technology required to operate the European websites, fulfillment centers, and related business activities; (2) marketing intangibles, including trademarks, tradenames, and domain names relevant to the European business; and (3) customer lists and other information relating to Amazon's European clientele. This cost sharing arrangement required AEHT to make an upfront ''buy-in payment'' to compensate Amazon US for the right to use Amazon US' pre-existing intangibles. This case shows the importance of considering potentially comparable uncontrolled transactions of the taxpayer with unrelated parties.

Amazon valued the buy-in payment at $254.5 million based on the ''unspecified income-based method'' (similar to the residual profit split method in which future income streams attributable to the intangibles are allocated between pre-existing and subsequently developed intangibles). At trial, Amazon supported its position on the buy-in payment through the comparable uncontrolled transaction (CUT) method by separately valuing each category of the Amazon intangibles and assuming specific useful lives for the pre-existing intangibles (e.g., useful life of six years for the website technology).

The IRS argued that the above buy-in payment is inconsistent with the arm's-length standard. It applied a discounted cash-flow (DCF) methodology to the expected cash flows from the European business of Amazon, and determined a buy-in payment of about $3.6 billion. The DCF method applied by the IRS assumed infinite useful life, regarded the three groups of intangibles as integrated components of an operating business (rather than three separate groups of assets), and incorporated elements of value that were not transferred under the cost sharing buy-in transaction.

COPYRIGHT © 2018 BY THE BUREAU OF NATIONAL AFFAIRS, INC.

The U.S. Tax Court in *Amazon.com, Inc. v. Commissioner* rejected the IRS's application of the aggregated DCF method to determine the cost sharing buy-in payment for the pre-existing intangibles. It ruled that Amazon's CUT method with appropriate upward adjustments is the best method to determine the arm's-length buy-in payment.

The taxpayer's CUT method (consistent with the comparable uncontrolled price method under the OECD Guidelines) is basically an application of the relief from royalty method using a royalty rate based on the rates charged for the use of the intangibles between independent parties. Under this method, the income attributable to the intangible can be estimated based on a 'deemed royalty' payable for the rights to use the subject intangible. The application of this method depends on assumptions on the following parameters:

- Financial projections on AEHT's revenue base during the assumed useful life;
- Growth rates relating to AEHT's post 2011 revenues;
- Arm's-length royalty rates (expressed as a percentage of AEHT's revenue in the various years). With respect to the website technology, for example, taxpayer's experts derived a CUT by reference to the prices Amazon charged its Merchants.com clients for the technology needed to build and run those clients' e-Commerce websites. It was inappropriate to rely solely on the headline rates stated in the agreements with these clients, because the deals had multiple revenue sources, including ancillary services, such as fulfillment and customer service that Amazon US did not provide to AEHT. Hence, adjustments were performed;
- The discount rate used to convert projected future income streams (i.e. AEHT's projected royalty payments) into a lump-sum present value. The taxpayer used the WACC to estimate an 18 percent discount rate; and
- The useful life and decay curve within the useful life.

With respect to the valuation of the website technology, the table below presents for each of the main valuation parameters in applying the CUT method/relief-from royalty the major disagreements between Amazon and the IRS and the U.S. Tax Court decision.

Website Technology - Internal CUT Method Based on Merchants.com Transactions

This U.S. Tax Court decision is consistent with the 2009 U.S. Tax Court ruling on Veritas Software Inc. v. Commissioner (133 T.C. 297, 2009).

Experience with the U.S. Tax Court cases show that the application of valuation methods has led to huge variances between what taxpayers and the IRS thought were arm's-length results. In several cases U.S. tax courts preferred using actual market transactions (although not perfect comparables) as a benchmark from which to arrive at arm's-length results. In addition, a fact based analysis (e.g. to support a finite useful life) is important to substantiate the various valuation parameters.

7.3 State Aid Investigation of INTER IKEA Systems' Rulings On 18 December 2017, the European Commission (EC) announced that it has opened an in-depth investigation into two Dutch tax rulings of Inter Ikea Systems, a subsidiary of Inter IKEA group in the Netherlands. The EC is concerned that these two rulings may provide a selective tax benefit to Inter Ikea System in breach of EU state aid rules.

Ikea operates under a Franchising business model since 1980. All Ikea shops worldwide pay a franchise fee of 3 percent of their turnover to Inter Ikea Systems. In return, the Ikea Shops make use of inter alia the Ikea trademark and receive know-how.

In a 2011 restructuring Inter Ikea Systems bought the intellectual Property from I.I. Holding, a subsidiary of Inter IKEA group in Luxembourg, and financed this acquisition with an intercompany loan. One of the rulings involves the endorsement of the acquisition price and the interest paid by Inter Ikea Systems.

The EC announced that it will evaluate whether the acquisition price adequately reflects the contribution made by Inter IKEA Systems to the value of the franchise business, and whether the level of interest reflects economic reality.

8. U.S. Tax Cuts and Jobs Act

The U.S. tax reform bill, which was signed into law on December 22, 2017 (commonly known as the ''Tax Cuts and Jobs Act'' or ''TCJA''), represents the most significant change to U.S. tax law since 1986. Changes include the reduction of the U.S. federal corporate income tax rate from 35 percent to 21 percent, limitation on interest deductions, and changes in the treatment of foreign income. These changes will need to be considered in their totality to gauge the impact on the valuation parameters used in applying the various valuation approaches (e.g., cash flows, and discount rate), and hence TP valuations.

In addition, the following changes (effective for tax years starting after December 31, 2017) may impact TP valuations involving the U.S.:

- Workforce in place, goodwill, and going concern value are intangible property within the meaning of section 936(h)(3)(B);
- The authority of the Secretary to specify the method to determine the value of the intangible property regarding outbound restructurings of U.S. operations and intercompany pricing allocations; and
- Granting the authority regarding the use of aggregate basis valuation and applying the realistic alternative principle.

9. Concluding Remarks

In view of the ongoing business restructurings of MNEs and the related TP consequences, international organizations, such as the OECD, the EU and the UN, have provided guidance on TP valuation. The guidance provided by these organizations should be considered in valuing the inter-company transfer of something of value (e.g., intangibles). Each of the guidance is specific and useful in light of the specific facts and circumstances of the case at hand.

A transfer pricing valuation should consider the following elements:

- Carefully assess the nature of the transaction and consider the critical fact and circumstances which might impact the nature of the transaction based on a functional analysis;
- Select the most appropriate economic valuation technique;

COPYRIGHT © 2018 BY THE BUREAU OF NATIONAL AFFAIRS, INC.

Parameter	Amazon	IRS	Tax Court
Royalty Rate	1.4%.2.4%	4%	3.05% (adjusted for ancillary services / volume)
Useful Life	6 Years	"Indefinite"	7 Years
Decay Curve	Relative Contribution Approach	Persistence Approach	Relative Contribution Approach
Tail Period	3.5 Years at 0.2%	"Indefinite"	3.5 years at 0.4%
Revenue Base (Post-2011 Revenues)	3.8-4% Growth Rate (50% Declining Balance Method)	8-22.5% Growth Rate (Goodwill Impairment Model)	3.8-4% Growth Rate (50% Declining Balance Method)
Discount Rate	18%	14%	18%
Beta	2.00 (monthly data)	1.55 (weekly data)	2.00 (monthly data)
Value	$117M-$182M	$3.34 billion	

- Substantiation of assumptions used in applying the valuation method based on a fact-based analysis (e.g., finite useful life) and consider potentially comparable uncontrolled transactions (e.g., internal CUP in supporting the arm's-length nature of royalty rate);
- Prepare documentation to satisfy TP documentation requirements; and
- Conduct scenario analysis; and
- Monitor closely ex-post outcomes compared to ex-ante projections in case of HTVI transactions (i.e. perform post transfer pricing valuation test).

Author Information

Clive Jie-A-Joen and Fan Bai work in the transfer pricing team of Simmons & Simmons LLP and are active in the field of transfer pricing valuation. Liu Lu works as Tax Manager Transfer Pricing, Europe, at Prologis Management B.V. in the Netherlands. Any errors or admissions are those of the authors, and this article is written in their personal capacity.

COPYRIGHT © 2018 BY THE BUREAU OF NATIONAL AFFAIRS, INC.