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"Transfer Pricing: Valuation method in case of companies based on high-valuable intangible assets"

RELATORE:

CH.MO PROF. Antonio Parbonetti

LAUREANDO: Francesco Girotto

MATRICOLA N. 1106186

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Sommario

Introduction

When we refer to Transfer Pricing we are talking about a general phenomenon that affects the daily life of the Large Multi-National Enterprises (MNEs).
These are companies operating on a global level and they are able to decide where to establish the operative branches and how to structure and finance themselves in order to identify and to take advantage of different market opportunities.
Our focus will be on this kind of enterprises and not on the Small Medium Enterprises, not complex and developed enough to implement any Transfer Pricing Policy.

Referring to this topic we mean the need of the MNEs "to price, for tax purposes, their internal or intra-group transactions and calculate profits as if the transactions had taken place between independent businesses". (OECD, 2012, p.14)

That is for sure the heart of the topic that in basic words is possible to summarize as "arm's length principle".

In order to respect this principle, important for the compliance with the rules issued by the OECD, several methods are available to price the intra-group transactions and to verify from the Tax Administration point of view that the Taxpayer is acting according to the arm's length one.
The majority of the methods implies a constant comparison with some comparable companies, chosen based on different criteria. The comparability analysis is performed every time is possible, but what if the market does not exist? Just think about the issues in valuing a software like iTunes, unique and without a real market, but with a great power of affecting the income of Apple. Or, how to value transactions involving hard to value intangibles, i.e. assets not developed yet and with a potential of income hard to estimate?

These are just few doubts about the challenges of this topic regarding special kind of companies, mainly the ones that operate on a large scale with the intangibles, from an accounting and operative point of view. In fact, if we referred to industrial companies, like in the automotive sector or more in general, in the manufacturing, the main challenges would be finding the proper comparable in terms of size, income, operations, but no problems would arise in terms of pricing, just because the market exists and it is well developed.

However, the operational point of view is not the only one to take into account.

In fact, we should not forget about the taxation perspective, root cause of every Transfer Pricing policy.

Let's make an example, to describe why this topic is on the spotlight.

Assume there is a Multinational company called A, that has 3 subsidiaries, one in a Low labor cost country, called L, one in a Tax Haven, called H, and the other one where the products is distributed called U, where the life cost is more expensive.

Starting from this point, in L the products are developed and they are sold to H at a low price. So low profits, low tax bill. H sells at an incredibly high price to U, almost at the same price that U distributes the products to its own market. So U buys at a high price and sells almost at the same one. Low profit, low tax bill. How about H? It has bought at a low price and it has sold at a high one, huge profit, but almost tax free rate, so low tax bill. This is how the Companies most often work and how they are always seen by the public institutions. [1]

Then, if we take into account another point view, i.e. from the companies, according to the EY survey in 2010, "the 32% of the respondents ranked Transfer Pricing as one of the most important tax challenges facing their group". (J. McKinley, J. Owsley, 2013, *Journal of Accountancy*). This is probably due to a great arbitrage problem derived by the competing objectives of three parties:

1. The revenue-maximizing objective of the domestic tax authority;
2. The revenue-maximizing objective of the foreign tax authority;
3. Tax-minimizing objective of the taxpayer. (J. McKinley, J. Owsley, 2013, *Journal of Accountancy*)

These purposes lead to a difficult and complex legislation in terms of International Taxation, and still, issues for double taxation arise every day.

This is just the beginning of the several concerns that this topic may offer.

Another example might be the sensitivity of the intra-firm trade prices to the tax rates of the Countries under focus. Apparently this might appear easy, simply answering that the shift of

[1] Inspiration for the example taken by the web page of Tax Justice Network, section Transfer Pricing. Available at the link below in the web reference section.

income and loss is possible, with basic accounting tools, across the countries with lower/higher taxation.
This is a straightforward reasoning, but how to decide the percentage to transfer? Is there any specific formula that helps the companies to shift positive and negative component of income? If yes, how is it decided? Based on what? How may a tax administration shed the lights on specific transactions, made only with the purpose to lower the EBIT? How to deal with the Tax Authorities' needs of every Country where the group operates? Which are the main features regarding the documentation to be compliant at international level and also at the national one?
These are just few considerations, from two different perspectives, regarding this interesting and complex topic that daily affects several kinds of decisions in a MNE.

The aim of this report is to shed the lights on particular operative issues by the taxpayer in order to understand all the process and the challenges incurred while dealing with intragroup transactions. We will explain the main methods indicated by the OECD, and a particular focus will be given to one method, especially indicated when unique intangible assets are the subjects of the inter-company transactions. This is for sure a specific kind of scenario, because every company is completely different, and when the market does not exist, all the instruments used for the comparability analysis become less efficient.
It will follow a practical example, trying to understand with numbers, what actually is dealing effectively with the challenges of the Transfer Pricing.

Chapter 1: Arm's length principle

Arm's length principle: what is it?

It is assumed the market forces are ruling the commercial and financial relations when independent enterprises interact each other. It is then assumed a different behavior when associated enterprises are having exchanges: probably their relations are affected in another way by external market forces. This should not be considered by the tax administrations as a clear attempt by the taxpayers to avoid taxes manipulating their profits. It could be difficult to simulate an arm's length price when actually no external market forces are involved.

However, if the intra-group transactions are not at arm's length price, there could be distortion in the tax revenue amount of the host countries. It is for this reason that all the OECD countries have agreed in applying the arm's length principle, ensuring in this way a fair treatment with the other enterprises acting in the territory.

The tax purpose is just the main reason, but not the only one to respect this principle: there could be governmental pressures (domestic and foreign country), internal budget to respect, certain thresholds to not cross, pressures from the shareholders, especially if the reporting for them is not at the consolidated level.

Anyway, it is possible to find several associated companies that operate as independent too, with a high level of autonomy, and this could result in a normal arm's length transaction even without any adjustment needed by the application of the Transfer Pricing Methods.

This below is the statement of the arm's length principle.

Article 9 of the OECD Model Tax Convention

"Where conditions are made or imposed between the two (associated) enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly". (OECD, 2010, p.33)

Trying to better understand the real meaning of this article, we can proceed with a separation in two paragraphs.

The first one puts the issue of comparability into perspective, highlighting the need of a balanced approach in terms of reliability and of burden it creates for taxpayers and tax administrations. This one is the origin of the comparability analysis and it creates the need for "a comparison between conditions (including prices, but not only prices) made or imposed between associated enterprises and those which would be made between independent enterprises, in order to determine a re-writing of the accounts for the purposes of calculating tax liabilities of associated enterprises authorized under Article 9 of the OECD Model Tax Convention" (OECD, 2010, p.34)

The second one states the need for the determination of the profits under arm's length accrual, to determine the quantum of any re-writing accounts.

Reasons for the arm's length

The principle has been adopted by all the OECD countries and it is going to be adopted also by others. There are several reasons, beside the ones above described, why this principle is so widely accepted.

First of all, it provides broad parity of tax treatment for the subsidiaries of a Group and independent companies. This ensures the absence of tax advantages and disadvantages from both sides.

Secondly, it is easy to apply to the majority of the cases. A lot of the associated entities that interact each other may find similarities and then comparable circumstances with the independent ones: referring to basic transactions of purchasing and selling of commodities, how much is the market developed to identify proper comparable entities? Quite a lot. This is just an easy case, but what if we took into account a Group that deals within itself with unique intangible or with highly specialized goods? There are some solutions to this kind of cases, included the Transactional Profit Split Method, of which we will discuss later.

However, there are some weaknesses and concerns regarding this principle.

An easy practical example regards the natural diversity of the transactions' nature. There could be several transactions that independent enterprises would not undertake. This is not just the outcome of a manipulation to avoid taxes, but it might be due to different commercial situations that a MNE may face. As the simple fact that a comparable circumstance does not exist, it does not necessarily imply that is not at arm's length.

Another aspect may just regard the issue in getting adequate information to apply the arm's length. This is basically due to the enormous amount of data needed by the taxpayer and by the tax administration to evaluate uncontrolled transactions and the business activities of independent enterprises. These data may be difficult to get for geographical reasons, they might be incomplete and hard to interpret. In other cases it can just be impossible to get them because they do not exist.

Another weakness concerns one of the main natural reasons of Group's existence: the economies of scale. The separate entity approach of the principle does not provide the whole picture of the Group and also does not reflect the real nature of the separate entity.

Regarding this point there is one alternative, the global formulary apportionment combined with unitary taxation.

This approach "would allocate the global profits of a MNE group on a consolidated basis among the associated enterprises in different countries on the basis of a predetermined and mechanistic formula". (OECD, 2010, p.37)

To apply the formulary there would be three basic components:

1. Determination of the unit to be taxed;
2. Determination of the global profits;
3. A formula for the allocation of the global profits to the unit.

The formula will be based on some combinations of variables, like costs, assets, payrolls, sales and it has not to be confused with the Transactional profit methods: in fact the last one will consider case by case, whereas on the other side the approach under focus establishes a predetermined formula.

Who surrounds the global formulary apportionment approach affirms that:

1. The economic substance of a multinational and its transactions would be prioritized, instead of the legal form in which a multinational organizes itself and its transactions; (2013, TaxJusticeNetwork)
2. It would provide greater administrative convenience and certainty for taxpayers;
3. The group has to be considered as a whole, with a unique accounting method;
4. Reduce compliance costs because just one set of accounts is needed for domestic tax purposes;
5. It would be compatible with the Country-by-Country reporting, according to TJN's senior adviser Richard Murphy. In fact this kind of reporting could be the accounting basis for formulary apportionment. It would also disclose any likely deliberate material mispricing of goods or services across international borders. (2013, TaxJusticeNetwork)

These are not convincing motivations for several reasons:

1. This approach is hard to implement in a way that protects against double taxation and ensures single taxation because of the predetermined formula. Hard to believe that all the countries would agree to a universal one.

2. The formula, even if it were accepted, it would be probably different for the different needs that every country has. On support of this, each country would like to emphasize the most important factors in its jurisdiction. So challenges in making an agreement about that.
3. Ineffective way of dealing with the exchange rate movements. The global formulary apportionment provides a formula, that if it relies on costs, the outcome "would be that as a particular currency strengthens in one country consistently against another currency in which an associated enterprise keeps its accounts, a greater share of the profit would be attributed to the enterprise in the first country to reflect the costs of its payroll nominally increased by the currency fluctuation. Thus, under a global formulary apportionment, the exchange rate movement in this example would lead to increasing profits of the associated enterprise operating with the stronger currency whereas in the long run a strengthening currency makes exports less competitive and leads to a downward pressure on profits." (OECD, 2010, p.39)
4. More data and information needed than the arm's length one in terms of documentation, because all the data of the group should be collected and presented to each jurisdiction in the respective currency.
5. Difficulties in determining the profit of the group, according to different jurisdictions and different accounting standards, especially for the intangibles' valuation.
6. The global approach, as the word indicates, takes all the group as a whole, and does not consider "important geographical differences, separate company efficiencies, and other factors specific to one company or sub-grouping within the MNE group that may legitimately play a role in determining the division of profits between enterprises in different tax jurisdictions." (OECD, 2010, p.40)

These are just some of the main reasons leading the OECD countries to adopt the arm's length one instead of the global formulary apportionment one, and considering there are no other developed principles, the first one is and will be the only one internationally recognized.

Guidance for applying the arm's length principle

Comparability analysis

As already mentioned several times, the key consideration for applying this principle is finding some "comparable" companies. With this adjective is simply implied that "none of the differences (if any) between the situations being compared could materially affect the condition being examined in the methodology (e.g. price or margin), or that reasonably accurate adjustments can be made to eliminate the effect of any such differences". (OECD, 2010, p.42)

With this explanation in mind, we can also understand the core of the topic when we perform this analysis. This is basically one assumption: one transaction between independent enterprises is involved if, and only if, there is no any more appealing alternative. Hence, a detailed study of the choices has to be conducted, and this is obviously not just focused on the cost convenience of one in comparison to another one, but is also referred to the different types of products, situations, forecasts and so on. Thus, to evaluate transactions between associated, these factors have to be kept in mind, in order to perform any needed adjustment to achieve the right comparability.

The performance of the adjustments is a fundamental part of every kind of methods provided by the OECD we would like to use. In fact, any accrual can be made to specific conditions. These ones are the objects of the analysis, whether you choose a traditional method like the CUP one, comparable uncontrolled price, where the comparison is between controlled transactions to similar uncontrolled ones, or a transactional one, where the comparison is on the profit margin indicators. Obviously, the differences have to be "material", i.e. they have to clearly affect the degree of actual comparability, where the latter has to be based on some factors. These might be some "characteristics of the property or services transferred, the functions performed by the parties (taking into account assets used and risks assumed), the contractual terms, the economic circumstances of the parties, and the business strategies pursued by the parties." (OECD, 2010, p.43)

Factors determining comparability: characteristics of the property or services transferred

As it is possible to imagine, differences in the specific characteristics of property or services are considered in the fair value in an open market.

The differences might differ in the case we are talking about transfer of tangible property, provision of services, and intangibles.

In the first case the concern is on the physical nature, on its quality and reliability, on the volume of supply.

For what regards the second one, we talk about their nature and extent.

In the end, about the intangibles, really important are the form of the transaction, the type of property, the duration and degree of protection, and the anticipated benefits from the use of property.

These factors are important especially for the comparable uncontrolled price method: any difference regarding the features under examination may directly affect the price and require an appropriate adjustment. In general, anyway, these characteristics are more important for the traditional methods than for the transactional profit ones.

Functional analysis

Another way to compare the transactions is through their functions. This simply means trying "to identify and compare the economically significant activities and responsibilities undertaken, assets used and risks assumed by the parties to the transactions". (OECD, 2010, p.45)

The functions should be analyzed and compared and in case there are material differences adjustments are needed. In case of a good comparison in terms of functions, i.e. most of the functions are in common, an analysis is needed on their frequency, nature and value to the respective parties.

As highlighted by the OECD, great focus has to be given to the assets used and risks assumed.

Obviously, it is a mistake to compare one new equipment with an old one, and it is also wrong making a comparison regarding one intangible used in two different ways.

A deeper attention regards the types of risks. These might be divided into four major categories:

1. Market risk: an example is about the fluctuations of the input cost and output price;
2. Investment risk: you can incur it investing in PPE;
3. Financial risk: interest rate volatility or currency exchange rate fluctuations;
4. Credit risk.

Regarding the first two, there is not too much to add. Regarding the third one, there is something interesting to say.

In fact, within a MNE, it is common to have a business strategy which deals with this kind of risks. There are also tools, like hedging arrangements, forward contracts, put and call options, swaps and so on. Then, within a group, associated enterprises may bear the risks each other.

This, in case of an unsuccessful hedging of the risk by a branch means the group might decide to hedge the risk by another one. This, "if not accounted for in the transfer pricing analysis, could lead to an inaccurate determination of the profits in a particular jurisdiction." (OECD, 2010, p.47)

Economic circumstances

"Ceteris paribus" is not just a Latin expression used by all the economists to draw some conclusions considering some conditions as given, but it is also an easy sentence to describe that the basic environment and set of rules, written or not, have to be taken into account when making this kind of comparison: it is impossible in fact comparing the African Market with the American one, the Banana Market with the Watermelon one and so on.
About the economic circumstances that may be relevant to consider it is important to remember the presence of substitute products or not, the level of demand and supply, the competitive positions of buyers and sellers, the geographic location, the cyclic nature and so on.

Business strategies

The business strategies are important for transfer pricing purposes and the followings are just few demonstrations.
If we consider for example innovation and product development, risk aversion, set of rules regarding the job, it is straightforward to understand how much these may affect the final price of products, services, etcetera.
Fundamental is also considering any kind of long-term strategy, like a market penetration or a patent development.
Regarding the first one several considerations should be added.
In fact when there are unusual advertising transaction costs, it is possible to forecast a future market penetration strategy.
Furthermore, it is important also understanding if the nature of the relationship between the parties to the controlled transaction would be consistent with the taxpayer bearing the costs of the business strategy. An easy example in an arm's length transaction a company that just operates as a sales agent and it does not participate in the long-term market development will never bear the costs of a market penetration strategy.

Recognition of the actual transactions undertaken

This phase, ordinarily, consists in an examination of the controlled transaction as normally undertaken and structured by the associated enterprises.
However, as stated by the OECD Guidelines, there could be two exceptions to this rule, where it is advised to consider the transactions disregarding of the structure adopted by a taxpayer.
The first one is when the substance and form of the transaction are different. Here, as always in accounting, the main principle "substance over form" is the one to follow. To better understand that, let's follow the example.
Focus on a controlled transaction, that is an investment in an associated in the form of interest-bearing debt, but comparing it to an arm's length one, and keeping in mind the economic circumstances of the borrowing company, it seems more to a normal subscription of capital. Thus, in this case, the tax administration should not make any analysis taking into account the loan, whereas it should consider the subscription of capital.[2]
The second one arises where there is conformity between substance and form, but the "arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner and the actual structure practically impedes the tax administration from determining an appropriate transfer price." (OECD, 2010, p.52)
A related example involves a long-term contract, lump-sum payment, regarding the sale of unlimited entitlement to the intellectual property rights arising as a result of future research for the terms of the contract. This might appear a normal transfer of commercial property, but it is not properly correct to think that the terms between independent enterprises would be the same.[3]
In this case the conditions should be adjusted as another kind of agreement.

Losses

Reporting a loss is something completely natural for a company, reporting it for two or three years in a row it is possible too, especially during some macro-economic crisis, but if the losses are continuous, an independent enterprise would not be able to survive, at least not if it does not change anything.

[2] Example freely inspired by the OECD Transfer Pricing Guidelines of 2010.
[3] Example freely inspired by the OECD Transfer Pricing Guidelines of 2010.

Within a MNE group, anyway, this may happen, just because the interests of the group are more important than the ones regarding just one branch, and then several explanations may be given, like for example achieving a market penetration in the long-term through lowering the prices. Obviously, also this last case has to be just for a reasonable period of time. If it continues for a period longer than a reasonable one, it could indicate that the taxpayer is lowering the profit on purpose to lower the income and to avoid taxes. Then, the transfer pricing should be examined.

The effect of government policies

It is common that some interventions by the government affect the normal way of doing business of the companies. This may result in more controls, in changes, in different policies that rule the exchange rate or whatever.

Usually, the effects are visible just on the Country where the government operates, and they have to be considered just on that market.

Furthermore, often this kind of policies directly affects the final consumer, and this would not change anything to the enterprise.

However, there is a kind of policy that for sure affects the business life of the associated: the prevention, or “the “block” of the payment of an amount which is owed by one associated enterprise to another or which in an arm’s length arrangement would be charged by one associated enterprise to another.” (OECD, 2010, p.55)

One linked example is when exchange controls affect the transfer of interest payments on a loan between two branches located in two different countries. From a transfer pricing point of view, there is no simple solution to address the problem to whom and where. One solution might be applying the arm’s length viewing the intervention as a condition affecting the terms of the transaction. To apply the arm’s length anyway we should find a similar transaction between independent enterprises, which is unlikely, because a normal company would never enter into a transaction if she knows she will find problems in getting paid. Two approaches might be used.

One possibility is to treat the payment as having been made between two independent companies with the assumption that a company would have insisted to be paid by some other means.

Another one is to defer both the operating result of the taxpayer.

Summary

Here in this chapter we have tried to explain the basic principle that rules all the directives in terms of transfer pricing.

After the introduction, another alternative has been shown, analyzing pros and cons of using the formulary apportionment, and comparing it to the arm's length one.

Later on, a great focus has been given to the importance of the comparability analysis and the main factors to consider.

What we have figured out is that lots of external factors have to be kept in mind when comparing associated with independent enterprises, and it is not enough reducing it to size and nature of the products offered.

Several examples have been shown to highlight the issues with loss-making companies and with the effects of the policies decided by the government, the differences arising from the various business strategies and the importance of the circumstances.

With this information in mind we are ready to move on and to analyze the different methods offered by the OECD and by the literature on this topic.

Transfer Pricing Methods

Introduction

As introduced above, there are several and different methods to measure the transfer pricing, and all of them aim to identify the correct comparable arm's length transaction.

The OECD provides two different kinds of categories: the traditional transaction methods and the transactional profit ones. There are also others, but no internationally recognized.

To decide which method is the one to apply for a particular case, a deep analysis about strengths and weaknesses has to be conducted, understanding the nature of the transaction is mandatory, a check of the information available is fundamental. According to these factors and to several others the most appropriate method must be chosen.

The main difference between the two categories is the focus of the study.

For what concerns the first category, it is recognized as the most direct mean of "establishing whether conditions in the commercial and financial relations between associated enterprises are arm's length." (OECD, 2010, p. 59)

The focus is more on the transaction itself, and to the margins associated.

On the other hand, about the second one, the attention is given to the company's margins, more appropriate when no reliable information are available on the transaction.

Beside all the features that are part of the study in this context, the general rule is that, if two methods belonging to both categories are applicable, the preference is on the traditional one. The concept is clear: differences in price are easy to trace and to substitute.[4]

Regarding the "other methods", they are allowed if the prices provided by them are in line with the arm's length. However, if the OECD methods are more appropriate given the circumstances, these ones have to be chosen. If they have not, an explanation is needed.[5]

[4] As described in the OECD Guidelines of 2010, "this is because any difference in the price of a controlled transaction from the price in a comparable uncontrolled transaction can normally be traced directly to the commercial and financial relations made or imposed between the enterprises, and the arm's length conditions can be established by directly substituting the price in the comparable uncontrolled transaction for the price of the controlled transaction." (OECD, 2010, p. 60)

[5] The Guidelines are not mandatory, but they are strongly recommended. However, if other methods are chosen, "their selection should be supported by an explanation of why OECD-recognized methods were regarded as less appropriate or non-workable in the circumstances of the case and of the reason why the selected other method was regarded as providing a better solution." (OECD, 2010, p. 61)

Traditional transaction methods

As already mentioned, the traditional transaction methods are the ones used when comparing the transactions at arm’s length.

These ones are the comparable uncontrolled price method or CUP method, the resale price method, and the cost plus method.

Comparable uncontrolled price method

This is the most appreciated and the most used method provided by the OECD.

In general it “compares the price charged for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances.” (OECD, 2010, p. 63)

A transaction for being eligible to be measured with this method should present one of the two conditions here below:

1. the differences (if any) between the transactions or between the enterprises under focus do not materially affect the price in the open market;
2. Easy adjustments can be made to eliminate the material effects of such differences.

These conditions are really difficult to meet. Generally it is really hard to find comparable controlled transactions with comparable uncontrolled ones with no material differences affecting the price. In fact, even in the case the activities undertaken are similar enough to generate the same overall profit margin, a small difference in the property transferred in the controlled and uncontrolled transactions may be material. However, here it is possible to apply some adjustments.

As already highlighted, the CUP is the preferred one when we talk about commodities transactions.

With the term “commodities” we mean “physical products for which a quoted price is used as a reference by independent parties in the industry to set prices in uncontrolled transactions. The term “quoted price” refers to the price of the commodity in the relevant period obtained in an international or domestic commodity exchange market”. (OECD, 2015, p.53)

It is natural to imply that, when evaluating comparable uncontrolled transactions, these are made at arm’s length using the quoted price, considering the last one as “widely and routinely used in the ordinary course of business in the industry to negotiate prices for uncontrolled transactions comparable to the controlled transaction.” (OECD, 2015, p.53)

Beside all the comparability factors described in the Chapter I to take into account when comparing the transactions, the main ones to consider when talking about commodities are certainly the ones related to the product and its market: the physical features and quality; the contractual terms such as volumes traded, period of the arrangements, the timing and terms of delivery, transportation, insurance, and foreign currency terms. Especially regarding the volumes traded, discounts are typical in commerce, and some issues may arise when using the quoted price. It is correct to deduct the different trade discount in case of a transaction of 100 pieces in comparison of what it is possible to get in a transaction of 1000 pieces. So, how to use the quoted price? Is it correct to use it? When adopting the quoted price we are also analyzing the type of market involved: if in the business the discounts are common, undoubtedly there will be information about the amount and how to perform the transactions. Considering the market then, if the conditions between associated enterprises are different from the conditions between independent enterprises, and these differences materially affect the price, "reasonably accurate adjustments should be made to ensure that the economically relevant characteristics of the transactions are comparable." (OECD, 2015, p. 53)
In the end, when we refer to quoted price, the pricing date deserves a special focus.[6]
This is crucial in demonstrating, during an inquiry, the consistency of the conditions under study. It's important to refer to the actual status of the things at the moment of the transaction was done, otherwise the analysis would be distorted. In this case, an accurate adjustment should be needed.[7]

Pros and cons of the method

Advantages:

1. it's a two-side method, so it does reflect the agreement conditions between two independent parties and it avoids the need to find out the tested party;
2. Considering it is a two-side method, it avoids the double taxation issues arising with one-side methods.

Disadvantages:

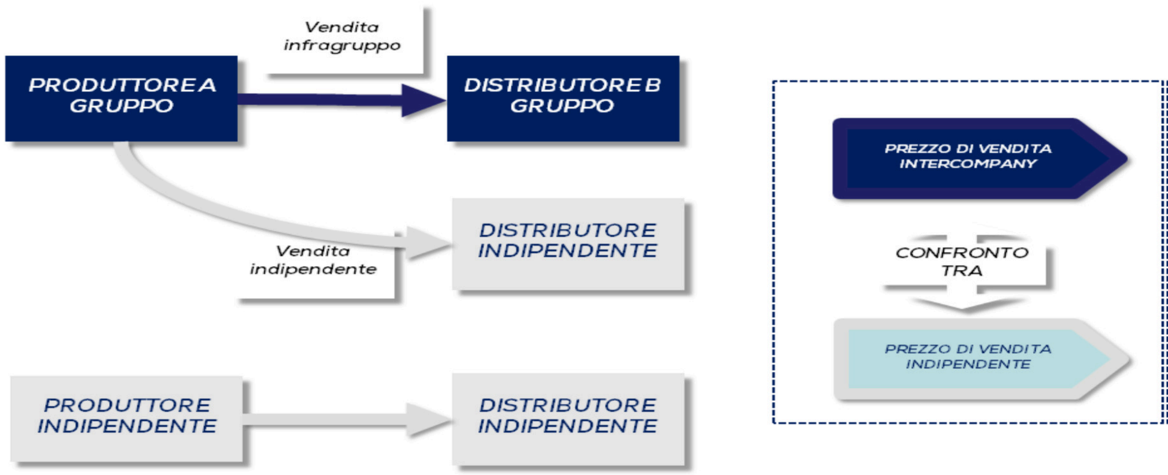
[6] The OECD report of 2015 identifies it as a particular relevant factor, "which refers to the specific time, date or time period (e.g. a specified range of dates over which an average price is determined) selected by the parties to determine the price for commodity transactions." (OECD, 2015, p. 54)

[7] "If the pricing date specified in any written agreement between the associated enterprises is inconsistent with the actual conduct of the parties or with other facts of the case, tax administrations may determine a different pricing date consistent with those other facts of the case and what independent enterprises would have agreed in comparable circumstances (taking into considerations industry practices)." (OECD, 2015, p. 54)

1. It is too much dependent on the product comparability factors, enabling in this way hard to identify a proper comparable transaction.

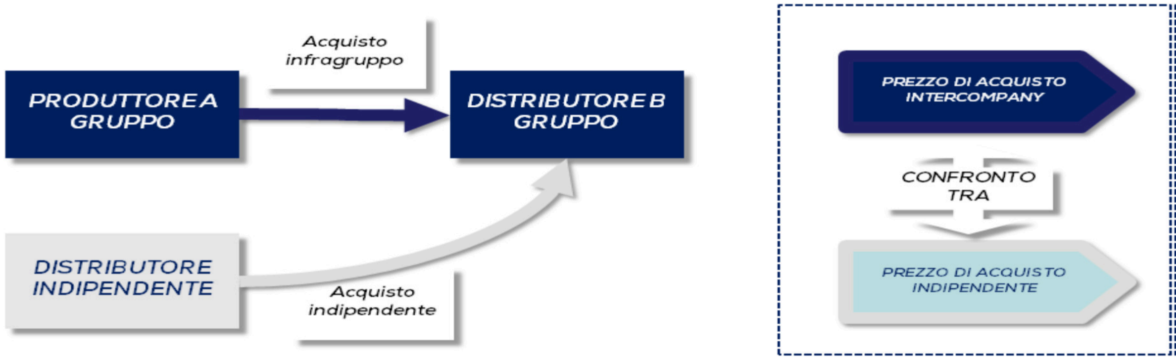
Scheme to summarize in case of selling

1.1. Picture



Scheme to summarize in case of purchasing

1.2. Picture



Resale price method

General features of the method, considering a manufacturer and a seller

After having analyzed the first traditional method, we move forward to the resale price method. This method consists in 3 phases:

1. selection of the reference price: the one at which the product that has been purchased from an associated enterprise is resold to an independent one;

2. reduction of the resale price by an appropriate gross margin calculated lump-sum representing an amount that reasonably covers the operating expenses of the reseller;
3. After the reduction, other reasonable adjustments connected with the purchase of the product, arm's length price comparison.[8]

OECD affirms: "this method is probably the most useful where it is applied to marketing operations". (OECD, 2010, p.64)

The resale price from which the analysis may start may be taken from an internal comparable or from an external one.

In the first case the focus is on the reseller margin in the controlled transaction compared to the same reseller margin in comparable uncontrolled transactions.

In the second one, the reference may be the resale price margin of an independent company earned in comparable uncontrolled transactions.

Due to the nature of the variable under investigation, according to the general principle ruling the comparability analysis regarding the comparability of the transactions, generally few adjustments are needed to account for product differences. This is the opposite of the CUP method. This is because the margins are less influenced by the differences of the products.

This does not mean the product comparability is not important, because in case of broader product differences, also the gross margins may be affected. Furthermore, clear it is that a closer comparability of products enables a better efficiency of the analysis.

However, this method is more appropriate while analyzing other comparability factors than the product features. An easy example could be the case when an associated company that does not own a unique intangible asset uses other attributes to add value to its products, like the functions performed, or the economic circumstances. Thus, if the transactions are comparable except for the product itself, the resale price method might be preferred to the CUP method.[9]

There are other relevant factors while dealing with this method such as the material differences in carrying out the business between the associated enterprise and the independent one when choosing the resale price margin of an independent company in a comparable transaction. (OECD, 2010)

These differences may have a material impact in affecting the level of profitability but they may be irrelevant regarding the price of the products in the open market. OECD suggests "these types

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[8] Scheme taken from the OECD (2010).

[9] OECD (2010) states that in this case "the resale price method might produce a more reliable measure of arm's length conditions than the CUP method, unless reasonably accurate adjustments could be made to account for differences in the products transferred." (OECD, 2010, p.67)

of characteristics should be analyzed in determining whether an uncontrolled transaction is comparable for purposes of applying the resale price method". (OECD, 2010, p.67)

Other really important differences are the ones between the functions performed: if they are material, adjustments are needed, as it is for the product differences.

This method is easily applicable when the reseller does not add value to the product. More difficult is the case when the distributor also processes the product and it adds value. It can be hard to deal even when the reseller contributes to the value of the intangible associated to the product which is owned by the associated enterprise.

This method may be easier to apply in certain circumstances than in others. In fact, if we consider the case of a traditional distributor, who just buys and sells at a higher price the goods, the resale price margin cannot be too high and it is easy to identify. On the other hand, if the reseller has also other activities to perform such as the marketing of such goods, it bears special risks, or contributes substantially to the creation or maintenance of intangible property associated with the product, the resale price margin will be high.

In the case of a chain of distribution

Until now we have thought the process as a linear one, where there are two companies, one that produces and the other one that buys and resells. Now, we can assume there is an intermediate company that sells to the distributor the products, with its supplier as original producer.

Most likely this intermediate company will add value too and it will resell the product at a higher price, fact that might be interesting and important from a tax administration point of view. If it is not possible to identify the real value added or the real economic performance performed by the intermediate company, "then any element in the price that is claimed to be attributable to the activities of the intermediate company would reasonably be attributed elsewhere in the MNE group, because independent enterprises would not normally have allowed such a company to share in the profits of the transaction". (OECD, 2010, p.69)

Pros and cons of the method

Summarizing, these are the pros and cons of the method.

Positive factors:

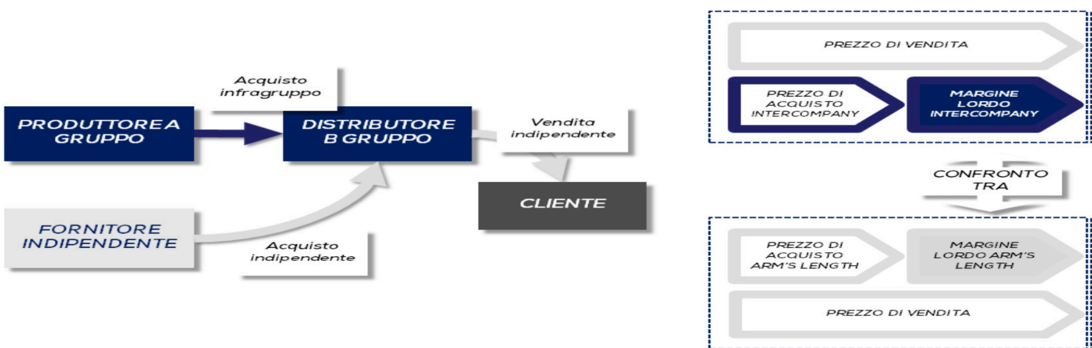
1. If we consider the functional analysis, the products are less important in the comparison, so it is less sensitive than the CUP;
2. According to the gross margin, it is not relevant the economic result of the companies, like losses due to specific strategic market decisions or to management inefficiencies.

Negative factors:

1. due to the fact that the method is more focused on the functions performed and on their similarity, the differences between them may be hardly represented by accounting information and they might be expensive to find out; these kinds of data are discretionary, more deeply, the criteria adopted to classify the costs are not universal and these have to be known before the comparison;
2. this method is hard to apply in case the distributor has different kind of value adding operations through special functions;
3. It is a one-side method, and this might lead to double taxation phenomena.

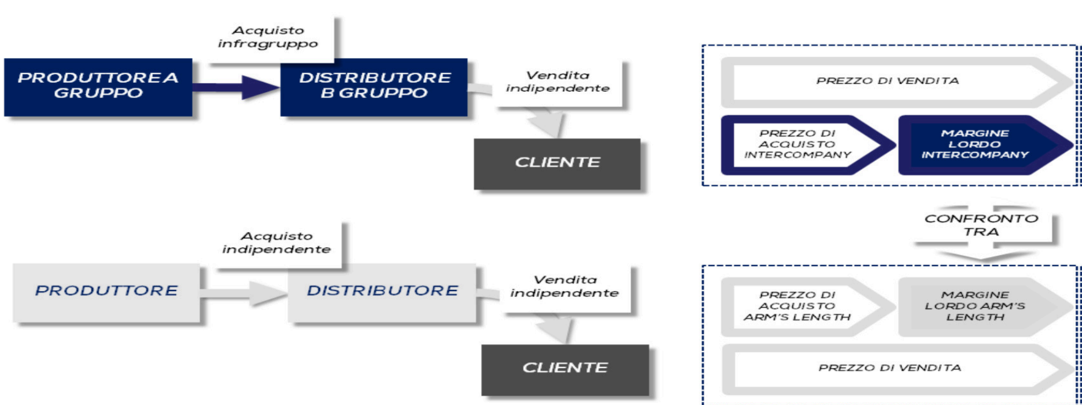
Applicative scheme in case of internal comparable:

1.3 Picture



Applicative scheme in case of external comparable

1.4 Picture



Cost plus method

General features of the method

We are now at the last of the traditional methods described by the OECD: the cost plus method. We can divide the process in various phases:

1. The starting point is the cost incurred by the supplier of property (or services) in a controlled transaction for property transferred or services provided to an associated purchaser;
2. An appropriate cost plus mark-up is then added to this cost, to make an appropriate profit in light of the functions performed and the market conditions;
3. The final result of the first 2 phases may be regarded as an arm's length price of the original controlled transaction. [10]

As OECD states, this method probably "is most useful where semi-finished goods are sold between associated parties, where associated parties have concluded joint facility agreements or long-term buy-and-supply arrangements, or where the controlled transaction is the provision of services." (OECD, 2010, p.71)

Like in the resale price method there are two kinds of approaches:

1. Using the internal comparable: comparing the cost plus mark-up of the supplier in the controlled transaction with the one earned by the same supplier in a comparable uncontrolled one;
2. Using the external comparable: the reference is on the cost plus mark-up earned by an independent enterprise.

In identifying a comparable transaction, the same reasoning of the resale price method works here. The focus is more on the comparability of the functions, than of the products. As always, whether there are material differences affecting the variable under focus, in this case the cost plus mark-up, reasonable accurate adjustments are needed.

One of the main issues in applying this method is the challenge in finding proper comparable companies due to different costs' classification.

Hence, the classification is generally in three categories: direct, indirect and "other" costs, including for example administrative or supervisory costs. This distinction is crucial when calculating the gross or the net margin. Usually the mark-up is applied to the gross one, obtained as the difference between revenues and direct plus indirect costs. However, there may be cases that

[10] Scheme taken by OECD 2010, Transfer Pricing Guidelines.

the cost plus method may consider costs included in the third category too. Moreover, moving on across the jurisdictions, not always the boundary is so strict between the three categories. This might be a problem in the application of the method.

Furthermore, remembering this separation, OECD suggests that some events may arise:

1. If expenses reflect a functional difference (just considering assets used and risks assumed) which has not been taken into consideration while applying the method, an adjustment to the cost plus mark-up may be required;
2. If the expenses reflect additional functions divided from the activities tested by the method, separate compensation for those functions may need to be determined;
3. If differences in the expenses of the parties being compared merely reflect efficiencies or inefficiencies of the enterprises, as would normally be the case for supervisory, general, and administrative expenses, no adjustment to the gross margin may be appropriate.[11]

If these circumstances arise, it would be appropriate implement the result got with this method with another method.

Moreover, important is the accounting consistency for the comparability analysis. In case the accounting standards are different between the jurisdictions, adjustments are needed to enable the costs' comparison.

Pros and cons

Summarizing, these are the pros and cons of this traditional method.

Positive features:

1. Due to the fact it works using the comparability of the functions, the products involved in the transactions might be different, then it is less sensitive than the CUP;
2. It is particularly appropriate when analyzing the branches of the group that just act as manufacturers without bearing high risks.

Negative features:

1. For a proper application of the method, the costs' bases of the tested party and of the comparable companies should be homogeneous: this feature, actually, is hard to find

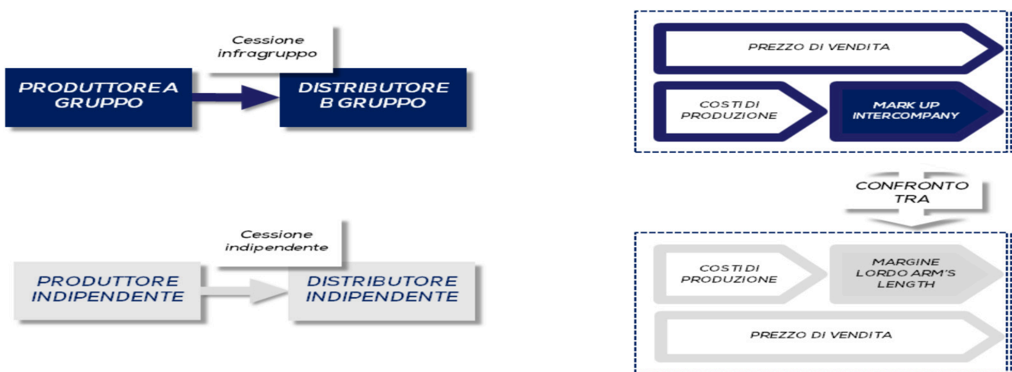
[11] OECD 2010, Transfer Pricing Guidelines, p. 73

because it requires to identify differences in the functions, management inefficiencies or specific strategic decisions;

2. As mentioned above, one of the main problem is the difficulty in being aware of the accounting information. This is due to different standards around the world, different routines applied by the companies, different kinds of data possible to get in some commercial databases.
3. It is a one-side method and it requires the identification of a tested party. This tested party has to have simple and usual operations, without giving any contribution to unique intangibles. This is hard to find.
4. The functional comparison is most of the times difficult to apply because many commercial databases do not supply enough information on the functional profiles of the companies.

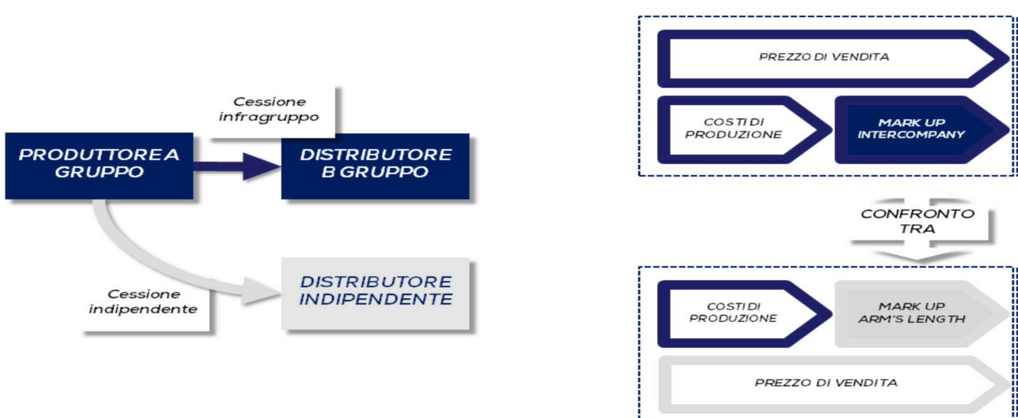
Applicative scheme in case of internal comparable

1.5 Picture



Applicative scheme in case of external comparable

1.6 Picture



Transactional Profit Methods

After having described the traditional methods, now we proceed on the description of the transactional profit ones.

These are particularly appropriate when some circumstances arise like for example:

1. “Each of the parties makes valuable and unique contributions in relation to the controlled transaction;
2. Where the parties engage in highly integrated activities;
3. Where there is no limited publicly available reliable gross margin information on third parties.” (OECD, 2010, p.62)

This kind of methods examines the profits earned from particular controlled transactions.

As indicated by the OECD the “profit arising from a controlled transaction can be a relevant indicator of whether the transaction was affected by conditions that differ from those that would have been made by independent enterprises in otherwise comparable circumstances.” (OECD, 2010, p.77)

Transactional net margin method

The method under focus considers the arm’s length price starting from the net profit arising from controlled transactions, relative to an appropriate base that a taxpayer realizes from a controlled transaction. (OECD, 2010)

It presents some similarities with the others two one-side methods described above, as the Resale Price and the Cost Plus method. It follows then the definition of internal and external comparison. Hence, ideally, to start the comparability analysis we should start from an internal comparable. Then, the reference to the comparable uncontrolled transactions would be the net profit indicator relative to the result earned in comparable controlled ones. If it is not possible to find the proper internal comparable, we should look for the net margins “that would have been earned in comparable transactions by an independent enterprise”. (OECD, 2010, p.78)

As it works for the other two methods, a functional analysis is needed to determine if the comparability of the transactions is reliable or if it needs further adjustments.

It is not advised when all the parties make unique and valuable contributions to intangible. It is accepted if one of these does not make any unique contribution.

Guidance for application

The TNMM is one of the most versatile methods provided by the OECD, and it is the first candidate to be applied anytime the traditional ones are not appropriate or they do not ensure a proper comparison.

However, to respect a standard of comparability, there are different aspects to take into account.

First of all, if we consider a functional analysis, essential for the method, a mere similarity of the functions does not imply a reliable comparison. What if, for example, two similar functions, but two different sizes of the companies? Or two different markets?

Secondly, when adopting an external comparison, this level of similarity between the associated and the independent enterprise has to be really high, and not just limited to product's or function's similarity.

Furthermore, few words are needed while discussing about the features of the net profit indicator used for the TNMM.

This indicator may be influenced by different factors:

- "By some factors that do not have an effect (or have a less substantial or direct effect) on gross margins and prices, because of the potential for variation of operating expenses across enterprises;
- By some of the same factors, such as competitive position, that can influence price and gross margins, but the effect of these factors may not be as readily eliminated." (OECD, 2010, p.81)

Considering these factors depending on the facts and circumstances, the net profit indicators may be less or more sensitive than gross margins. As OECD states "the net profit indicators can be less sensitive than gross margins to differences in the extent and complexity of functions and to differences in the level of risks. On the other hand, depending on the facts and circumstances of the case and in particular on the proportion of fixed and variable costs, the transactional net margin method may be more sensitive than the cost plus or resale price methods to differences in capacity utilization, because differences in the levels of absorption of indirect fixed costs would affect the net profit indicator but may not affect the gross margin or gross mark-up on costs if not reflected in price differences." (OECD, 2010, p.81)

Moving on, better explaining the concept of net profit for the OECD, it should contain "only those items that directly or indirectly relate to the controlled transaction at hand and are of an operating nature." (OECD, 2010, p.83) Hence, in the composition of the net profit should be excluded all the costs and revenues not related to the controlled transaction materially affecting the comparison. It follows that the non-operating items too, like the interest income and expense, if not related, should be excluded. Regarding the exceptional and extraordinary costs, instead, the dispute is hard: usually they should be excluded because they do not affect the normal condition of the transaction, but other times they might be considered as well, to better understand the economic situation/condition of the enterprise under focus.

In the end, serious issues may arise when dealing with foreign exchange gains or losses in determining the net profit. Here the features to consider are: are they of trading nature? Is the tested party responsible for them? Then, it has to be considered any hedging of the foreign currency exposure on the commercial credits and debts. In effect, as OECD affirms "if a transactional net margin is applied to a transaction in which the foreign exchange risk is borne by the tested party, foreign exchange gains or losses should be consistently accounted for". (OECD, 2010, p.85)

Pros and cons

The TNMM presents several strengths' point:

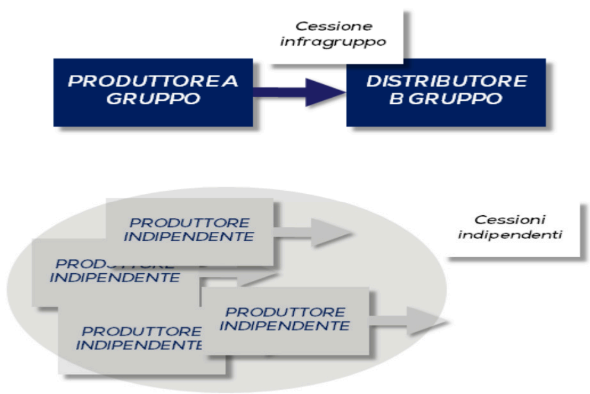
1. The net profit indicators are less affected by transactional differences than is the case with price, as used in the CUP method;
2. The net profit indicators may be more tolerant to some functional differences between the controlled and uncontrolled transactions than gross profit margins;
3. It avoids the problem of the lack of clarity in the public data with respect to the classification of expenses in the gross or operating profits;
4. As it is a one-side method, it is necessary to examine a financial indicator for only one of the associated enterprises.

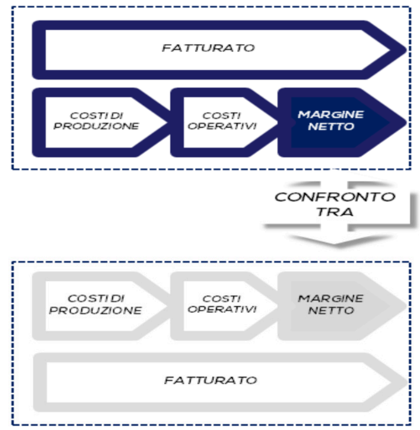
Cons:

1. The net margin may be affected by other factors that do not hit price or gross margins between independent parties;
2. Considering this method is applied to only one of the associated enterprises, and the several factors unrelated to transfer prices may affect net profits, there could be an insufficient standard level of comparability.

Applicative scheme

1.7 Picture





Transactional Profit Split Method

This is the last method provided by the OECD, and it is applied if all the others do not find the correct application to the case. This is especially used when evaluating companies and transactions that make valuable and unique contribution to the intangibles.

The aim of the method is to determine with which proportion some independent enterprises would share between them the profit of a comparable transaction.

The Profit Split estimates the net profit earned by controlled transactions and it splits it among them according the share of contribution in the same way as if it were under uncontrolled transactions.

Contribute may be decided in two ways:

1. The contribution analysis: the split is decided according to the value of the functions performed involved in the transaction;
2. The residual analysis, divided in two phases:
    - To every part involved in the transaction is attributed an income share as basis for the functions undertaken. This is chosen comparing it to independent parties.
    - The other part of the income is then allocated on other kinds of criteria: how much of the intangible they develop, the R&D expenses, the relative contractual agreements, the risk borne or using external data from the market.

The second method is the most used.

Now, through the guidance, we will focus on the advantages and of the issues of this method, particularly useful for our future analyses.

Guidance for application

The TPS method is the most complex but also the most reliable in difficult cases, like for example when the companies involved both make valuable and unique contributions to the intangibles.
It is based mainly on the “profit split”, so this should be:

- Consistent with functional analysis;
- Consistent with the determination of the combined profits;
- Consistent with the type of profit split approach;
- Capable of being measured in a reliable manner.

As already mentioned above, there are various approaches for splitting the profits: the contribution analysis and the residual analysis.
The contribution method is basically “a division between the associated enterprises based upon a reasonable approximation of the division of profits that independent enterprises would have expected to realize from engaging in comparable transactions.” (OECD, 2010, p.97)
For this division, comparable data are needed and if not available, the split should be based taking into account the relative value of the functions performed, not forgetting the assets used and the risks borne.
For what concerns the residual analysis, this is mainly made by two stages:

1. Each participant is allocated an arm’s length remuneration for its non-unique contributions in relation to the controlled transaction in which it is engaged;
2. The residual after the first stage is then allocated between the parties based on the analysis of the facts and circumstances. (OECD, 2010)

These are the main methods provided by the OECD, but in some cases an alternative approach might find an application: the split would be based on the discounted cash flow of the controlled transactions over the anticipated life of the business. This it would be appropriate when analyzing a start-up, or more generally, where it would be possible to estimate with a certain degree of certainty the capital involved and the sales related. (OECD, 2010)
However, as the OECD states, this method would be affected by the discount rate chosen, that most likely would be compared to the market rate for that industry. This is hard to apply, because “industry-wide risk premiums used to calculate the discount do not distinguish between particular companies let alone segments of businesses.” (OECD, 2010, p. 98)

Important for the application of these methods is to find the correct amount of the profits to be split.
First of all, obvious to say but not easy to do, is to find the correct and proper transactions. Then, after having selected the transactions, an adjustment is needed according to some accounting standards that have to be chosen, and they have to be the same for all the associated enterprises, despite the jurisdictions or local laws.
Identifying the transactions there is one important assumption that tax administration should know: "the taxpayer could not have known what the actual profit experience of the business activity would be at the time that the conditions of the controlled transaction were established." (OECD, 2010, p.99) This is fundamental in order to respect the arm's length principle because independent companies could only have relied upon projections under similar circumstances. (OECD, 2010)
After having identified the proper transactions and being certain about the reliability of the comparison through the use of the same accounting standards, it is essential to define the nature of the profits under focus. They should be of operating nature and the main criteria to split them are:

- They have to be reasonably independent of transfer pricing policy formulation;
- They have to be supported by comparable data, internal data, or both.

To apply these criteria, there are some allocation keys that can be a figure (based on similar transaction evidence) or a variable. If the allocation keys are more than one, it would be necessary weighting the allocation.
These allocation keys should be based on capital, or on costs, less often on the time spent if there is a strong correlation between the time spent and the creation of the combined profits.
The asset based can be used when there is a strong correlation between tangible or intangible employed and creation of value in the context of the controlled transaction.
The cost based is the easiest one, but is not appropriate where each party contributes different valuable intangibles.
In the end, about the allocation based on time, some issues may arise because there can be a time lag between the time when expenses are incurred and the time when value is created (OECD, 2010, p.103)

Advantages and disadvantages

Pros:

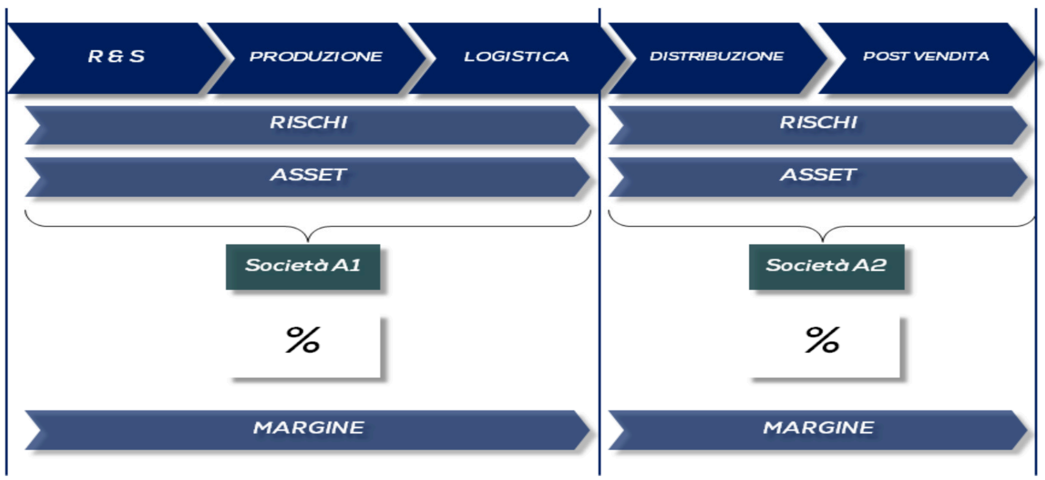
1. The Profit Split is a two-side method and it enables a better allocation of the margins in comparison to the one-side method.
2. It is especially indicated when all the traditional methods are not appropriate because comparable companies are missing and it is the best when the transaction is between two highly integrated subjects and they make valuable and unique contributes to the intangibles.

Cons:

The method is based on detailed accounting information of both companies and sometimes, due to different criteria of accounting or more simply, because the data are not available, it might be difficult to apply and to verify.

Applicative scheme

1.8 Picture



Summary

In this chapter our focus has been on the methods available under the OECD directives.

After a careful and deep analysis the result of our study highlights our attention should be more on the transactional profit methods for the aim of our report.

Starting from the first analyzed, the transactional net margin method is the most used when the traditional methods are not enough to check if the prices of the controlled transactions are at arm's length or not. This however, sometimes is applied “without adequately taking into account the relevant differences between the controlled and uncontrolled transactions being compared.” (OECD, 2010, p. 105)

When these differences of the transactions are materially affecting the net profit indicators, some adjustments according to what is described by the OECD have to be made.

Secondly, another conclusion is the mistake to generalize the conditions in which these kinds of methods have to be performed. In effect, a case-by-case study has to be led every time these methods seem the ones to be applied, taking into account "the strengths and weaknesses set forth above for a particular transactional profit method to be applied, the comparability (including functional) analysis of the parties to the transaction, and the availability and reliability of comparable data." (OECD, 2010, p. 105)

In the end, the transactional profit split method deserves a particular attention for our scope.

When dealing with highly integrated companies that make unique and valuable contributions to the intangibles they own is the best case of application of this method.

Now we will move further highlighting the special considerations to do when dealing with the intangibles for transfer pricing purpose, trying to better understand the challenges and to find the correct approach when evaluating this kind of cases.

Intangibles

As mentioned above, the purpose of this report is to shed the lights on a difficult matter regarding the transfer pricing of intangibles. Before proceeding with all the attentions required, we have to clarify what we mean with the term “intangible”.

An intangible, as stated by the IFRS in the IAS 38, is “an identifiable non-monetary asset without physical substance.”

Typical examples of intangibles are patents, brands, trademarks and so on, that, in most of the bigger companies, are accounted for millions or billions of dollars. What is really important to understand is the impossibility to “touch” this asset, to give it a value because sometimes the market is missing, and to understand or to estimate the expected benefits.

To better acknowledge the importance of this category of asset, generally and then more specifically for transfer pricing purposes, we can go through the IAS 38.

IAS 38

The principle supplies some tools for the recognition and for the measurement of the intangible assets.

Regarding the recognition, the process is divided in two levels:

1. Identification;
2. Criteria to recognize.

According to the first point, the two basic factors to consider are divisibility and the origin from contractual or legal rights. With the adjective “separable” we think about the capacity “of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, identifiable asset or liability, regardless of whether the entity intends to do so.” (IFRS, 2014)

About the second instead, the conditions to respect are sufficient and necessary:

- Likely, the entity will earn economic benefits related to the asset;
- The asset’s cost may be reliably measured.

The difficult point about these two conditions is not the probability of future earnings related to it, especially if it has been bought separately or during a business combination. It is the valuation.

The valuation is different if we consider intangibles that have been purchased and others that have been internally generated.

So, generally speaking, the starting point is the recognition at cost.
The cost can be the purchase price or any direct expense of preparing the asset. In the case of an acquisition due to a business combination, the cost is the fair value at the date of the acquisition. (IFRS 3)
In the case of internal generated goodwill, no recognition is possible as an asset.
Internal generated intangibles, arising from research, shall not be recognized as assets. If there have been some expenditures on research, so high R&D costs, these have to be accounted as expenses when they are incurred.
There are strict criteria, all of them have to be satisfied, to recognize an intangible asset internally generated from development:

- "The technical feasibility of completing the intangible asset so that it will be available for use or sale;
- Its intention to complete the intangible asset and use or sell it;
- Its ability to use or sell the intangible asset;
- How the intangible asset will generate probable future economic benefits. Among other things, the entity can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset;
- The availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset;
- Its ability to measure reliably the expenditure attributable to the intangible asset during its development". (IFRS, technical summary IAS 38, 2014)

Considering these strict requirements, just to make it clear, brands that have been generated internally should not be recognized as assets.
Moving forward to the models for the valuation, it is possible to use cost or the revaluation one.
Taking into account the first, after having been recognized, the value has to be the cost less any accumulated amortization, less any impairment losses.
Regarding the second, instead of the historical cost less the items above written, there will be the fair value less amortizations and impairment losses.
A big question mark about the accountability of the intangibles regards the concept of "useful life": according to what the IFRS 3 states, there are 2 possible ways to define it:

- "the period over which an asset is expected to be available for use by an entity; or

- the number of production or similar units expected to be obtained from the asset by an entity" (IFRS, technical summary IAS 38, 2014)

Given these two definitions, it may arise that the length of useful life may be finite or indefinite.
If it is finite, the amount will be depreciated as it works for the tangible assets.
If it is indefinite, the intangible will be subject of impairment test as provided by the IAS 36, i.e. on annual basis or every time it results that the impairment test is needed.

Intangibles for the OECD

For the OECD, to give a definition of "intangibles" the focus is not on the accounting features but is on the possibility to give a price to the assets involved in certain transactions.
This fact may result in some important differences from the definition given by the international accounting standards. In fact, to consider an item an "intangible" also for transfer pricing we have always to refer to the Article 9 of the OECD Model Tax Convention. This implies, for example, the R&D costs that, as seen above, normally they are not recognized as intangibles but they are expensed. However, as easily to guess it, they may generate in the future a high value and this may lead to be interesting for transfer pricing purpose.
A clear difference from the definition given by the IAS 38 is also the importance of the "division" concept: the acquisition of intangibles may be done separately obviously, but it may also be in combination with other assets. The same reasoning works for the contractual and legal protection.[12]
What it really matters for transfer pricing purpose is the specific identification of the intangibles. This has to be done through a functional analysis, highlighting the way how the intangibles interact each other in the value creation, their functions and the "specific risks assumed in connection with the development, enhancement and maintenance". (OECD, 2015, p.68)
Anyway, there is the chance to find some categories also from a Transfer pricing point of view, trying to specify it through exact definitions. This does not mean that during a transfer pricing analysis the easy categorization among one of them implies that the intangible does not have to be identified with specificity.
The categories are: commercial and marketing intangibles.

[12] The OECD, in the report of 2015 explains that the legal protection and the concept of division is not a necessary condition. (OECD, 2015, p.67)

The following has to be considered, as specified in the Guidelines, about the Marketing Intangible: "An intangible that relates to marketing activities, aids in the commercial exploitation of a product or service, and/or has an important promotional value for the product concerned. Depending on the context, marketing intangibles may include, for example, trademarks, trade names, customer lists, customer relationships, and proprietary market and customer data that is used or aids in marketing and selling goods or services to customers". (OECD, 2015, p.69)
Another one, particularly important for our scope is this one: ""Unique and valuable" intangibles are those intangibles that are not comparable to intangibles used by or available to parties to potentially comparable transactions, and whose use in business operations (e.g. manufacturing, provision of services, marketing, sales or administration) is expected to yield greater future economic benefits than would be expected in the absence of the intangible." (OECD, 2015, p.70)

Patents

"A patent is a legal instrument that grants an exclusive right to its owner to use a given invention for a limited period of time within a specific geography." (OECD, 2015, p.70)
In this way the commentary of the Guidelines describes the concept of Patent.
This commercial intangible may be the result of high investments in research and development, or it may be just the result of a small improvement to an existing product but that completely change the value and the way of producing this kind of goods.
The possibilities to earn from a patent are through the patentable goods, by the licensing agreement, or by a normal sale of the intangible.

Know-how and trade secrets

This kind of intangibles is, differently from the patent one, not protected or covered by legal rights. As indicated by the OECD "Know-how and trade secrets generally consist of undisclosed information of an industrial, commercial or scientific nature arising from previous experience, which has practical application in the operation of an enterprise." (OECD, 2015, p.70)
From this it follows that is on the company the responsibility to non-disclose the secrets and the data. Considering there are not specific tools or legal ways to do that, OECD explains that "unfair competition or similar laws, employment contracts, and economic and technological barriers to

competition" may help in granting the important information within the enterprise. (OECD, 2015, p.71)

Trademarks, trade names and brands

"A trademark is a unique name, symbol or picture that the owner or licensee may use to identify special products or services of a particular manufacturer or dealer and, as a corollary, to prohibit their use by other parties for similar purposes under the protection of domestic and international law." (OECD, 2010, p.194) This is the definition used by the Guidelines.

The trademarks are officially registered in a system, and the rights arising from it may force the competitors to not use the same trademark.

Differently from the patent, of which the protection rights last for a certain period of time, the trademark may continue without any limit if the use is demonstrated and the registration renewed.

A trade name, often the name of the company, "may have the same force of market penetration as a trademark and may indeed be registered in some specific form as a trademark." (OECD, 2015, p.71)

If we consider the brand, there are not too many differences from the trademarks. Sometimes, in some specific contexts, it can be a synonym of the trademark with social meaning.

The social significance does really matter for the value of the trademark, because if it is not a big deal creating a new one, it is for sure really expensive trying to maintain its value: many investments in advertising and in marketing campaigns have to be made. The brand means reputation, and the reputation means value, quality, and this makes valuable all the products.

Trademark is not just the name of the enterprise but it might be also the name of a collection, of a product line, of a specific product.

Goodwill

With the term "goodwill", according to the context, we can refer to different kinds of definitions.

Usually, from an accounting perspective, this term is simply the difference between the price paid to buy a company less the fair value of the assets and the liabilities. In other contexts, this difference reflects an effort sustained by the acquirer to buy the purchased company, because of expected future economic benefits. These ones, as definition, are not "individually identified and separately recognized." (OECD, 2015, p.72) It is officially affirmed that goodwill cannot be transferred separately from the business assets to which it's related.

From a transfer pricing point of view it is not relevant which kind of definition has to be used to describe the goodwill: what it really matters is identifying it when some particular transactions are involved, and to price it.

This really matters, for example, when the reputation of a company is particularly important because allows it to charge higher prices than another company that does not have this important asset. The difference between the two prices apparently applied for the same product may be called goodwill, or ongoing concern value, but for our purpose the important thing is to identify it and to take it into account in order to establish arm's length prices.

Fundamental to remember is that the accounting or the business valuation does not ensure a proper measure of the goodwill for transfer pricing purpose. However, as the OECD reminds us "accounting valuations and the information supporting such valuations can provide a useful starting in conducting a transfer pricing analysis." (OECD, 2015, p.73)

Comparability factors related to intangibles

As already mentioned, dealing with the intangibles is slightly different from dealing with the tangibles. First of all the lack of the market, secondly the difficulty in identifying the portion of the price related to the intangible, thirdly the not clear definition and the difference with the international accounting standards.

However, it is possible to compare somehow the intangibles through an analysis of the comparability factors.

Starting from the assumption that there are a lot of "unique" intangibles, if there is awareness that this asset may give a particular advantage in the market, the analysis of the transactions chosen as comparable has to be particularly detailed.

A typical intangible analysis might go through the following order, as described below.

One of the most important factor to consider is the exclusivity: the possibility to use a particular asset for a determined or indefinite period of time gives the chance to get a higher share of market. A typical case might be the analysis of a patent that for definition may exclude the others to use it. Secondly, another feature to take into account is the extent and duration of legal protection. Being aware of the existence of rights associated to certain types of intangibles, the possibility to keep the others out from the market ensures a high profitability of the asset. Then, if the intangible has a finite useful life, more important will be the duration of these rights. Obviously, if there are two comparable inventions covered by patents with different duration, the value of the patents will be different.[13]

Thirdly, the competition may be affected by the width of geographic area protected by the rights associated to the asset: clear it is that worldwide protected patent is much more valuable than a single one protected patent.

Further, an aspect not too much under the lights while dealing with this topic is the duration of the useful life. Clearly, another story is in comparison to tangible assets, and the duration of useful life may be dependent on the duration of legal protection associated and on the rate of technological change. If the intangible may provide a longer competitive advantage in the market, it is definitely more valuable.

An interesting feature to write about is the stage of development. In fact "it is often the case that an intangible is transferred in a controlled transaction at a point in time before it has been fully demonstrated that the intangible will support commercially viable products". (OECD, 2015, p.95)

This may alter the price and the future economic benefits expected. Then it follows that if it is known that the intangible is commercially viable it will be more valuable than another one not yet established. Furthermore, it is fundamental to calculate the probability that other changes or developments will raise a commercial benefit in the future. (OECD, 2015)

Gradually, another important discussion point may regard the rights to enhancements, revisions, updates. Believing in a simple assumption that making some improvements to something already completed is faster and cheaper than creating it *ex novo,* this may grant the chance to maintain a longer competitive advantage.

In the end, the last but not the least, the merely expectation of future benefit is the easiest factor to consider. Sometimes without a real comparable in the market is hard to find the similarity between potential and actual profits. Anyway, if it is possible to forecast a high profitability deriving from the asset, the comparability may not be performed with intangibles that give an average industry profit. On this purpose, the OECD concludes that "any factor materially affecting the expectation of the parties to a controlled transaction of obtaining future benefits from the intangible should be taken into account in conducting the comparability analysis." (OECD, 2015, p.96)

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[13] In the report of 2015 of the OECD at p.94 affirms "for intangibles with limited useful lives, the duration of legal protections can be important since the duration of the intangible rights will affect the expectation of the parties to a transaction with regard to the future benefits from the exploitation of the intangible."

Highly uncertain valuation, Hard-to-value-intangibles (HTVI)

The valuation when doing a transfer pricing assessment is not always easy. We have analyzed in the second chapter the different methods offered by the OECD and the conclusion we made is that, especially dealing with the intangibles, sometimes the valuation may not be estimated with high level of certainty. This may happen especially when, at the time of the transaction the intangible is not at the final stage of development, and a forecast of the expected benefits arising from its completeness has to be performed.

When calculating the anticipated benefits, a detailed analysis of the most probable events is required. Doing so, if the results are considered as reliable, simple projections may be enough to fix the price of the transactions.

A deeper reasoning is required if the pricing arranged based on the results obtained while forecasting does not cover the risks arising in these uncertain situations. This could be the case to use a short-term agreement. As OECD suggests, it may "include price adjustment clauses in the terms of the agreement, or adopt a payment structure involving contingent payments to protect against subsequent developments that might not be sufficiently predictable." (OECD, 2015, p.108)

The use of contingent payments is useful especially when the intangibles are not fully complete and ready for being commercialized. Then, in this case, an arm's length transaction may establish any additional payment when any subsequent improvement in the development is reached.

The correctness of the results has to be checked by the tax administration, especially when there are claims by the taxpayer of some differences between the results got during an ex ante and ex post valuation. It may happen in fact, that after a transfer of an intangible at an early stage of development, its value raised a lot. The taxpayer may contest that the transfer has been made without taking into account the right considerations that some unforeseeable events changed the outcome expected, and it might claim for the difference. The tax administration, that for its nature, does not necessarily need specific knowledge about the business environment where the company works, it is completely dependent on the insights and information provided by the taxpayer under examination. However, if the tax administration identifies that there are differences between the projections ex ante and the results ex post of the pricing, and these are due to events easily foreseeable, it may suspect that there is an attempt of mispricing.

These events may occur particularly when dealing with the kind of intangibles called "hard to value intangibles". Trying to give a clear picture of what we are talking about, the definition is the following:

“The term hard-to-value intangibles (HTVI) covers intangibles or rights in intangibles for which, at the time of their transfer between associated enterprises, no reliable comparable exist, and at the time the transaction was entered into, the projections of future cash flows or income expected to be derived from the transferred intangible, or the assumptions used in valuing the intangible are highly uncertain, making it difficult to predict the level of ultimate success of the intangible at the time of the transfer.” (OECD, 2015, p.110)

The features of the transactions in which the HTVI are involved are described here below:

- “The intangible is only partially developed at the time of the transfer.
- The intangible is not expected to be exploited commercially until several years following the transaction.
- The intangible does not itself fall within the definition of HTVI but is integral to the development or enhancement of other intangibles which fall within that definition of HTVI.
- The intangible is expected to be exploited in a manner that is novel at the time of the transfer and the absence of a track record of development or exploitation or similar intangibles makes projections highly uncertain.
- The intangible, meeting the definition of HTVI, has been transferred to an associated enterprise for a lump sum payment.
- The intangible is either used in connection with or developed under a CCA or similar arrangements.” (OECD, 2015, p. 110)

To evaluate these transactions, it is necessary to start from the beginning, checking the fairness of the ex-ante arrangements. This is the standard approach, but anyway in some circumstances the valuation ex-ante is not required. The following is a list of the factors, where the presence of at least one of them, makes the valuation ex-ante not useful for our purpose:

“When the taxpayer provides:

1. Details of the *ex-ante* projections used at the time of the transfer to determine the pricing arrangements, including how risks were accounted for in calculations to determine the price (e.g. probability-weighted), and the appropriateness of its consideration of reasonably foreseeable events and other risks, and the probability of occurrence;
2. Reliable evidence that any significant difference between the financial projections and actual outcomes is due to:

- unforeseeable developments or events occurring after the determination of the price that could not have been anticipated by the associated enterprises at the time of the transaction;
- or the playing out of probability of occurrence of foreseeable outcomes, and that these probabilities were not significantly overestimated or underestimated at the time of the transaction;

3. The transfer of the HTVI is covered by a bilateral or multilateral advance pricing arrangement in effect for the period in question between the countries of the transferee and the transferor.
4. Any significant difference between the financial projections and actual outcomes mentioned above does not have the effect of reducing or increasing the compensation for the HTVI by more than 20% of the compensation determined at the time of the transaction.
5. A commercialization period of five years has passed following the year in which the HTVI first generated unrelated party revenues for the transferee and in which commercialization period any significant difference between the financial projections and actual outcomes mentioned above was not greater than 20% of the projections for that period." (OECD, 2015, p.111)

Cost contribution arrangements

Strictly linked to the challenges related to the valuation of the HTVI is the cost contribution arrangement. It is an agreement the parties make on the purpose of sharing the contributions and risks "involved in either the development, production, or acquisition of intangible or tangible assets, or the execution of services, with an expectation that the parties will enjoy the anticipated benefits to be derived from their contributions equitably." (Doonan, Lopez de Haro, 2015, p.1)
It is a common practice between subsidiaries of the same company, and it is especially arranged to find a balance between the contributions and the benefits arising from the cooperation.
The CCA about the development of the intangible and of the tangible assets is called asset-based CCA whereas the one related to service sharing is called service CCA.
What it really distinguishes an asset based CCA from the service CCA is the timing: if the service CCA is able to operate with actual profits, the asset based may be established just with the use of projections.

The evaluation of the CCA is based on the principle “substance over form”: this means that just the real risks, duties and the anticipated benefits on the CCAs parties are taken into account rather than the ones indicated on the agreement. This does not exclude, from a practical point of view, a continuous update by the parties of the agreement “to reflect an evolution of the arrangements on changing business needs and opportunities.” (Doonan, Lopez de Haro, 2015, p.1)

In the past the only requirements for a CCA were the consistency between contributions and benefits expected and the inclusion of the totality of the CCA’s parties. At the moment, anyway, the new OECD guidelines establish that all the parties must have the possibility to control and to bear the risks arising from the arrangement, and that they have to be explicitly interested in the CCA output. Clearly, the interest in the output has to be commercially rational, otherwise the CCA will be dismissed.

The definition of control on this purpose is the one given by the OECD: “the capability to make decisions to take on, lay off, or decline a risk-bearing opportunity presented by participating in the CCA, and the capability to make decisions on whether and how to respond to the risks associated with the opportunity.”(OECD, 2015, p.167)

Really important, especially for what concerns the asset-based ones, is the use of projections. This is a standard practice, and as always while dealing with the transfer pricing matters, the projections should be in line with what two independent enterprises would have done under similar circumstances. However, these projections may differ from what actually the companies realized. For this reason, if the business environment has been shocked by some relevant changes, some adjustments may be needed.

The focus on the context where the transactions are made is important also for the valuation topic: in fact, considering the business environment in which the companies operate, the value of the contributions has to be surrounded by the projections in that context.

To evaluate the contributions two kinds of methods are available: cost or function.

Generally the second is preferred because “cost is generally not permitted as an approximation of value under the guidelines, unless cost is considered the arm’s length price for the services (or function), or unless the value of any mark-up that is forgone is calculated and included as a preexisting contribution of value specific to that service function.” (Doonan, Lopez de Haro, 2015, p.2)

After the decision of the method and after its application, the control by the tax administration is performed: they can require to adjust the CCA’s contributions if the share of each participant has been determined not in the proper way. The adjustment has to be done following the domestic tax laws.

Documentation required

The OECD guidelines provides that the CCA should meet the conditions described below:

a. "The participants would include only enterprises expected to derive mutual and proportionate benefits from the CCA activity itself (and not just from performing part or all of that activity).
b. The arrangement would specify the nature and extent of each participant's interest in the results of the CCA activity, as well its expected respective share of benefits.
c. No payment other than the CCA contributions, appropriate balancing payments and buy-in payments would be made for the particular interest or rights in intangibles, tangible assets or services obtained through the CCA.
d. The value of participants' contributions would be determined in accordance with these Guidelines and, where necessary, balancing payments should be made to ensure the proportionate shares of contributions align with the proportionate shares of expected benefits from the arrangement.
e. The arrangement may specify provisions for balancing payments and/or changes in the allocation of contributions prospectively after a reasonable period of time to reflect material changes in proportionate shares of expected benefits among the participants.
f. Adjustments would be made as necessary (including the possibility of buy-in and buy-out payments) upon the entrance or withdrawal of a participant and upon termination of the CCA." (OECD, 2015, p.175)

Regarding the initial terms, these are the information that are relevant:

a) "a list of participants;
b) a list of any other associated enterprises that will be involved with the CCA activity or that are expected to exploit or use the results of the subject activity;
c) the scope of the activities and specific projects covered by the CCA, and how the CCA activities are managed and controlled;
d) the duration of the arrangement;

e) the manner in which participants' proportionate shares of expected benefits are measured, and any projections used in this determination;
f) the manner in which any future benefits (such as intangibles) are expected to be exploited;
g) the form and value of each participant's initial contributions, and a detailed description of how the value of initial and ongoing contributions is determined (including any budgeted *vs* actual adjustments) and how accounting principles are applied consistently to all participants in determining expenditures and the value of contributions the anticipated allocation of responsibilities and tasks, and the mechanisms for managing and controlling those responsibilities and tasks, in particular, those relating to the development, enhancement, maintenance, protection or exploitation of intangibles or tangible assets used in the CCA activity the procedures for and consequences of a participant entering or withdrawing from the CCA and the termination of the CCA;
h) Any provisions for balancing payments or for adjusting the terms of the arrangement to reflect changes in economic circumstances." (OECD, 2015, p.176)

Over the duration of the CCA term, the following information could be useful:

a) "any change to the arrangement (e.g. in terms, participants, subject activity), and the consequences of such change;
b) A comparison between projections used to determine the share of expected benefit from the CCA activity with the actual share of benefits;
c) the annual expenditure incurred in conducting the CCA activity, the form and value of each participant's contributions made during the CCA's term, and a detailed description of how the value of contributions is determined." (OECD, 2015, p.176)

Summary

In this chapter the aim has been identifying the objects under our focus. With the term “intangible” several meanings may be adopted, but for our purpose the one we mean is the one indicated by the OECD.

As previously anticipated, the intangibles are the most complex assets to value, whether from an accounting point of view either from a transfer pricing perspective. From the latter, we have seen different categories, focusing on the main aspects of each one. Even though that, however, if the item falls within some features easy to classify, this does not avoid the item by item approach needed while dealing with the intangibles for transfer pricing purpose.

After having discussed in detail about the different categories, the comparability discussion has highlighted once again the meaning of “unique intangible”, showing the issues of any other methods except the profit split. The factors to take into account when performing the comparison have been discussed, and the outcome of our analysis is the hard similarity between features like the exclusivity, the useful life and the future benefits expected.

One “alternative” to the profit split is for sure the cost contribution arrangement. The CCA is a common agreement around the world and considering its simplicity to apply, a broader application is probably expected in the future.

Profit split method

Introduction

As we have already mentioned several times, considering our main focus is on the treatment of the intangibles according to the transfer pricing topic, the method suggested by the OECD is the Profit Split method.

The topic of taxation of intangibles is at the moment under spotlight, especially after the double taxation problem arisen in Ireland involving the IT giant Apple. The heart of the problem has been the taxation of the profits share earned in Ireland, where the EU accused Apple of tax evasion and Ireland to not respect the international tax rules. The matter is basically fiscal, and this is not the proper site to discuss about it, but the reply of Tim Cook, current CEO of the American company contains the core of our study: the taxation of the real value added. Here below the crucial sentence of Cook, in the Apple customer letter of the 30th August 2016: “Taxes for multinational companies are complex, yet a fundamental principle is recognized around the world: a company’s profits should be taxed in the country where the value is created.” (Cook, 2016, customer letter). As we have explained earlier, the transfer pricing is most of the times associated to taxation issues, and the aim is to fairly price the inter-company transactions. The pricing of the transactions takes into account value of the assets, they are tangible or intangible. Considering in this specific case, according to Cook, the real value of the Apple’s products is not in the manufacturing or in the operations of the company, whereas in its powerful intangible activities, such as brand, patents and above all research costs. This is absolutely a simple view of the huge scandal that hit the European community and the company from Cisternino, but it is not a mistake affirming that the taxation of valuable intangibles is really complex, especially if related with the transfer pricing matter. How is it possible then, by Apple in this specific situation, and by the tax administration, to correctly tax the real source of value that makes Apple the most profitable company in the world? Among the OECD methods, according to the requirements listed by the organization, the most appropriate one in the case of transfer pricing of intangible assets is most likely the Profit Split. It is for this reason that in this chapter we will discuss about its evolution through the time since the beginning till the 2011 US Uniloc trial, event that sentenced the end of an old way of thinking, solving several doubts about the implications that this method has always created. From this then we will go through the OECD guidelines, in particular the post-BEPS features of the method, trying to understand what is changed and which kind of actions are required by the tax administration to verify the compliance of the transfer pricing set by the associated companies.

The rules

The rule of thumb

The 25 per cent rule, or rule of thumb, is an old and effective way of splitting the profits arising from the use of intangible assets. This has been formulated for the first time by Goldscheider in the 50s. The focus of his studies was on the licensing costs, i.e. on finding a price for the usage of a patent, trademark and this kind of intellectual property, alias called royalties.

The results of the studies, based on a Swiss subsidiary of a big American corporation are summarized by Goldscheider as: "the licensees tended to generate profits of approximately 20 per cent of sales on which they paid royalties of 5 per cent of sales." (Goldscheider, Jarosz, Mulhern, 2002, p.123)

Simply speaking, the rule is based on:

1. Some projections made ex ante about the profits arising from the patented product or simply from the product embedding the IP;
2. Profit projections then are divided by the expected net sales for the same period, giving a profit rate;
3. The profit rate will be multiplied by 25 per cent, ending in the royalty rate that has to be paid by the licensee to the licensor.

Hence, in this way, the rule allows the licensee, i.e. the user of the license, to retain about the 75% of the profits deriving from the usage of the IP.

The spotlight is on the licensee, the user of the IP, the one that has to pay the royalty and the one that has to make the deepest analyses about the convenience of undertaking this agreement, because it is on him the major responsibility to commercialize the product embedding the intangible under discussion. Then, the focus is on the "fully-loaded" profit, because it represents the real return. In fact, considering just the gross one, fundamental costs of the operating cycle to add value to the product would not be accounted, like administrative, marketing and research costs. According to Smith and Parr "omission of any of these expenses overstates the amount of economic benefits that can be allocated to the intellectual property. In a comparison of two items of intellectual property, the property that generates sales, captures market share, and grows, while using less selling and/or support efforts, is more valuable than the one that requires extensive advertising, sales personnel, and administrative support. The economic benefits generated by the property are most accurately measured after considering these expenses." (Smith, Parr, 1994, p.362)

For fully loaded profit, the choice is between the operating profit and the pre-tax profit. Studies demonstrate the legitimacy of the first choice. For example in fact, two licensees, one using a high leverage and the other one no, ceteris paribus, they will have two different pre-tax profits because of the deduction of the interests on the leverage, but the same operating profit. It follows the operating profit should be the correct indicator to use when applying this rule.

Justification for the rule

This profit split method is relatively easy to apply and probably its simplicity made its fortune. However, its simplicity is just one of the advantages when applying this rule.

First of all, there is historical evidence that a lot of licensing agreements have been established according to the 25/75 split.

Second, the 75 per cent represents the fair share for a licensee that is involved in the commercialization of the product licensed.

Third, considering the licensee has several investment opportunities, the power is on him for establishing "the rules" during the negotiation.

Fourth, the ratio 3:1 is quite common.

Fifth, "technology is the first of the 4 required steps of commercialization." (Razgaitis in Goldscheider, Jarosz, Mulhern, 2002, p.130)

Finally, usually there is a range for the indicator R&D to profits that varies between 25 to 33 per cent.

Critics of the rule

Despite the international success of this rule, several are the factors that have been contested.

First, it has been considered as "arbitrary". This is it because the fixed percentage of 25 is giving a boundary to the real valuation of a patent: this may be really innovative and change the market in which is created, or even may be almost useless because of simple improvements but not too value adding. Then, according to Berkman, "[The 25 Per Cent Rule does] not take into account specific circumstances that will determine the actual value of the patent at issue. No consideration is given to the number or value of economic alternatives or the incremental value of using the patented technology over other viable alternatives." (Berkman, 2002, 22)

Second, some authors are arguing if there is or there is not "indefiniteness". This is mainly due to the choice, already discussed above, of the gross or operating profit. As we said above, using the perspective of the licensee, the indicator to use is the operating one.
Third, some critics have been moved whether the IP is just a minority part of the product value. This anyway, is a useless critic, because the rule provides the possibility to make some adjustments, up or down, also depending on the contribution of the IP.
In the end, and this is a universal critic, is that the rule does not provide a reliable weight of incremental benefits. To this critic, the rule of thumb replies that it has to be applied jointly with another valuation method, but this does not imply it is a good starting point for negotiations.

Uniloc case and limitations of the method

There has been a moment when the rule of thumb has been not accepted and not applied. It happened in 2011, and it is known as Uniloc case, called like this because of the trial between Uniloc and Microsoft. That time the US Court of Appeals stated that the 25 per cent rule was not appropriate to the case. These are the words: "*the 25 percent rule of thumb is a fundamentally flawed tool for determining a baseline royalty rate in a hypothetical negotiation. Evidence relying on the 25 percent rule of thumb is thus inadmissible under Daubert and the Federal Rules of Evidence, because it fails to tie a reasonable royalty base to the facts of the case at issue*".[14]
This has been the first time where the critics of too much simplicity and too low specificity of the rule has been contested publicly, underscoring the importance of considering the particular case while valuing IP. This does not solve anyway the lack of data needed when performing a comparability analysis that somehow the rule of thumb does.
After Uniloc, other arguments arose about the limitations of the classic 25 per cent rule. These are the main ones:

1. Bundle of rights: in the original studies of Goldscheider there were different kinds of IP included, like patents, trademarks, at a royalty rate of 5 per cent. Probably, having considered them separately, the profitability would have been lower than 20 per cent and this would have headed to a lower royalty rate.
2. No market price available: according to the origins of the rule, the focus is on the licensee, then on its profitability, revenue and cost structure. This implies that a comparison to other

[14] Uniloc USA, Inc. v. Microsoft Corp., 632 F.3d 1292, (CA-F.C., 2011), page 1055.

licensee for the same license is not really needed, but this does not consider the objectivity of a price that a licensor would have asked, without taking into account the interests of the licensees.

3. No actual profits: as always the valuation ex ante risks to be slightly different than the ex post one. This means that several times the choice of undertaking a licensing agreement is based on projections that may be too optimistic, especially if these are related to a launch of a new collection. Hence, the risk of overpaying is real, especially if the launch will be a failure.
4. No stable profits: as mentioned above, the main costs to commercialize the products embedded of this IP are on the licensee. If the licensing agreement lasts for 10 years, clear it is the costs will never be constant throughout the contract. Same reasoning is valid for the revenues. Then it is hard to say if the royalties paid upfront are fair with the actual profits in respect to the foreseeable results.
5. International expansion: taking into account the origins of the Goldscheider's studies, the world was not so cosmopolite, and there were specific policies ruling the import/export matters. Then, it was also just the only way for a company to expand itself around the world. Now, just considering the European Union, how much the costs of import would be accounted? Simple, 0. Then it is clear how the cost structure changed in these last decades.
6. Value of IP increasing: it is unthinkable nowadays considering the percentage of profitability equal to 25 per cent as it was decades ago. In fact on average IP accounts for 80 per cent of the enterprise value.[15]

PPA: Purchase price allocation

As we have seen in the previous paragraph, there were, and there are, several concerns about the use of the rule of thumb.

These are the main ones: difficulty to find the data, the profitability of the licensed business is not shown whereas the contract is just focused on the royalty rate, and in the end the hard choice by the licensee to communicate his profit expectations to the licensor, against his own interests.

To overcome these problems and the numerous critics against the 25 per cent rule, the literature advises us to refer to another side of the accounting, the acquisition accounting, which "is the

[15] Binder, Ankler, Les Nouvelles, 2015, p.206

process of classifying, valuing, and accounting for all of the assets and liabilities that are included in the acquisition of a business." (Binder, Nestler, 2015, p.13)

In fact, an extremely useful tool to value the intangibles applying the profit split principle is through the use of the purchasing price data. These data reflect the present value of future profits the assets related to are expecting to earn. Obviously, considering the tangible assets this process is easier, the market exists and several comparable companies are available. Referring to the intangibles and to the goodwill the topic is more interesting.

Anyway, this kind of analysis is much better than the one needed while considering a licensing agreement. This is it especially for the long-term perspective adopted while acquiring a business instead of a 3-5 years licensing time.

This technique is also appropriate for starting a Transfer pricing analysis: if we refer to the trademark's value data, what we see is the value of the ownership of the intangible, which is the starting point for a reallocation of the intangible's ownership within the group. Furthermore, the profit split data reveal the profit expected from the use of the trademark. Hence, the profit can be allocated to branches based on their functions and expenses related to the asset, resulting in trademark royalty rates to be charged to the subsidiaries.

After this short overview we need to list the pros and cons of this technique.

Considering the limitations of the PPAs' use the first element is for sure the hard estimation of intangible's useful life. If an intangible has 10 years of useful life and another one 20, the first one is probably expecting the returns faster than the other one. This means that it is not allowed to use the same percentage of profit split if the useful lives are different.

Second of all, the value used is the fair value that is not properly the "market" one. This could be a useful approximation, by the way.

Thirdly, the different use of the data. As Binder and Ankler state "the data represent the view of the acquirer, not the previous owner. If the acquirer intends to restructure the business, or if he has only little use for a particular intangible, he might allocate only little value to it, while this particular asset had a higher value to the previous owner, and vice-versa." (Binder, Ankler, 2015, p.14-15)

Another point is the consideration of the liabilities involved. If in the PPA the acquisition is seen as an asset deal, the liabilities are not involved, otherwise they are. In the first case, however, the data must be adjusted by liabilities that are typical for the industry.

The last but not the least, the tax deductibility is an important factor. This may vary the intangibles value and the goodwill one.

Moving forward to the pros of the technique, some of them are pretty obvious.

The first one is absolutely the data availability. The possibility to have different data from the same dataset is extremely important.

The second one is still referred to the data, but to the quality. These data are checked and are compliant with all the accounting standards, the "results of valuations are cross-checked relative to each other and against the 100% threshold of purchase consideration effectively paid, and finally they are audited by CPAs". (Binder, Ankler, 2015, p.15)

Thirdly, they are based on transactions. This is relevant in comparison to the licensing valuation. Other kinds of valuations are accepted, like the multiples, and the prices paid are widely accepted.

Fourthly, the acquisition accounting gives more reliable data because the focus is on established business and not in new and risky licenses. This is well connected to the profitability, concept more appropriate for a long term perspective.

In the end the data are integrated. In fact "both price (value) of intangibles and profit-split relate to one and the same business". (Binder, Ankler, 2015, p.15)

BEPS: what does it change?

The OECD issued in 2015 a document related to the use of the Profit Split, in accordance with a project aimed at solving some international tax issues, called "base erosion and profit shifting".

We will go through the guidance to correctly apply the most complex transfer pricing method.

The focus of the method is on the split of the profits, based on the proportion of costs incurred by the subsidiaries to develop the intangible and its earnings related. The profit to be allocated may fall within two categories: anticipated or actual.

Usually the split of the actual one is considered the most appropriate method.

One of the reason why is because of the less dependency on assumptions, needed on the other case.

It is based on sharing the risks, where the first step is identifying them, then understanding how much each party bears them. This is helpful also in order to determine the allocation keys.

However, the choice of the method cannot be established without a proper functional analysis as support, in simple words, it is not appropriate to choose the method just for exclusion. Actually this means something straightforward: the concept behind the profit split is the allocation of profits and costs based on the risks borne. Then, if we consider a scenario where there is a transaction between two subsidiaries, and just one of the two actually suffers all the risks, the choice of the profit split is not appropriate.

We previously said that another reason to choose the profit split method is the lack of comparable companies in the market. But this is not enough to state the correctness of the selection. In fact, if the other party does not bear any risk, the adjustment and interpretation of inexact comparable data is considered more reliable and appreciated rather than the inappropriate application of the method under discussion.

A pretty obvious criterion to consider is the financial capability of the parties to take on the risks. Another fundamental factor to take into account is the level of integration of the activities within the group. According to the OECD, a high degree of integration is defined as "the way in which one party to the transactions performs functions, uses assets and assumes risks is interlinked with, and cannot be reliably evaluated in isolation from, the way in which another party to the transaction performs functions, uses assets and assumes risks." (OECD, 2016, p.9)

Following this definition it is necessary to introduce the concept of sequential and parallel integration. The first case refers to the performance of discrete functions in an integrated value chain, and in this situation "assets and risks involved in each discrete stage may be comparable to those involved in uncontrolled arrangements." (OECD, 2016, p.10)

If we consider then the second case, it is when there is a high level of commonality between the functions. Considering this kind of integration, the comparability is possible between the parties through a detailed identification of the actual transactions highlighting the risks and responsibilities assumed by the subjects involved. Knowing that in this condition the comparability is possible at the same point for multiple parties, the profit split method is the candidate to be the most appropriate one ceteris paribus.

4.1 Table: sequential vs parallel integration[16]

Indicators	**Sequential**	**Parallel**
Functions	Separate teams, reporting lines and stage gates for progression through the supply chain	Shared teams and common reporting lines.
Assets	Separable assets, from both a legal and economic perspective. Costs located in a single entity or able to be recharged to a single entity	Assets shared due to contributions from different sources and/or shared development, enhancement,

[16] Deloitte in OECD, 2016, p.105

	(subject to development, enhancement, maintenance, protection and exploitation considerations).	maintenance, protection and exploitation functions.
Risks	Economically significant risks managed and controlled by functions of a single entity that has the financial capacity to assume the risks.	Shared risks where the different components of risk (control and financial capacity to assume) are spread across multiple entities and not able to be separately priced.

Moving forward, one of the key points under discussion when talking about the application of the method is the importance of the contribution to the intangible, if it is "unique and valuable". As OECD suggests the contributions may have these features "in cases where they are not comparable to contributions made by uncontrolled parties in comparable circumstances, and their use in business operations represents a key source of actual or potential economic benefits." (OECD, 2016, p.10) Then, it would be quite clear thinking that most of the times, if the parties perform contribution like that, sharing the risks should be normal. However, as Deloitte highlights, "where a party to the transaction does make a unique and valuable contribution, but does not bear any risk that is economically significant, the business operations might rely on, for example, an external market which is more likely to yield external comparable data or have a reliable income stream that could be tested directly using valuation techniques." (Deloitte in OECD, 2016, p.106) From this it follows that in the condition described above, the most appropriate method should not be the profit split but the CUP. Further, always taking into account the contributions, an important factor to consider is their size: in fact the percentage should be almost equal, not for example a ratio of 10 to 90.

Some authors shed the lights on the relevance of the group synergies. These are for sure important, but their presence is not sufficient for the application of the PS. This does not mean that they should not be taken into account, but if there are no other criteria that suggest the use of the method, they may simply be used as allocation keys.

Guidance for the application

The guidance of the OECD tells to the taxpayer and to the tax administrations that there are two kinds of analysis broadly accepted for splitting the profits: the contribution and the residual one.

Beginning from the contribution one, the first step is to identify the combined profits, meaning in this moment the profits arising from the controlled transactions, and the second one the allocation "between the associated enterprises based upon a reasonable approximation of the division of profits that independent enterprises would have expected to realize from engaging in comparable transactions." (OECD, 2016, p.13) The reasonable approximation may be done with comparable data, if there are some, or based on the functional analysis, considering the assets and the risks involved.

Moving to the second one, the application is proper where it is possible to define the contributions of the parties in two categories and in two stages.

In the first stage "each party engaged in the controlled transactions is allocated an arm's length remuneration for those categories of contributions which can be directly valued, typically routine contributions for which reliable comparable can be found." (OECD, 2016, p.14)

In the second one, any remaining part would be allocated among the subsidiaries.

In this case, the OECD affirms that a residual analysis "in a transactional profit split of anticipated profits to set a price for the contribution made by the transferor, it is likely that projected income or cash flows of the transferee resulting from the transaction will be estimated over an appropriate period, deducting the income or cash flows associated with the activities that can be reliably benchmarked." (OECD, 2016, p. 14)

Furthermore, the guidance gives some tips regarding the criteria to use in order to split the profits. First of all, of absolute relevance, the parties have to choose the accounting policy in advance. This may have important effects within large international group resulting in huge differences between the branches, one above all for example is the difference in timing.

Secondly, the measure of the profits we have to know it is dependent on the degree and on the quality of the integrated operations and the sharing of the risks. For example, if we consider gross profits, the consideration to be done has to include not just the market risks, but also the efforts and the challenges involved in the production of the goods, taking into account also any intangible that most likely may affect the level of the profit. This, as OECD writes "may mean that the parties have integrated or joint functions and assets relating to the production or acquisition of goods and services." (OECD, 2016, p.15)

Another feature may let us comprehend the choice of the operating profit: it has to consider, beside the normal operating items, also any possible investment in intangible that may affect the profit.

Again, as OECD says "this may mean that the parties have integrated or joint functions relating to the entire value chain." (OECD, 2016, p.15)

Furthermore, profits to be split should:

- "Be reasonably independent of transfer pricing policy formulation, i.e. they should be based on objective data (e.g. sales to independent parties), not on data relating to the remuneration of controlled transactions (e.g. sales to associated enterprises),
- Be verifiable,
- Be supported by data of comparable companies, internal data, or both." (OECD, 2016, p.16)

These features are fundamental when it is time to decide if performing an allocation asset-based or cost-based.

About the asset based allocation, this may be possible wherever there is a strong link between tangible assets and the arising of value in the context of the controlled transaction. On the other side, regarding the cost based one, it is strongly advised every time there is a chance to delineate a strong correlation between the costs incurred and the relative value contributed.

However, this way leads to some issues.

The first one is about the nature of the contributions: if all the parties make some valuable and unique contributions to the intangible, the cost based factor is not appropriate to use "unless is a reliable measure of the relative value of those intangibles or costs can be risk weighted to achieve a reliable measure of relative value." (OECD, 2016, p.18)

Another one, and it is more relevant, is the difference in timing. In fact it might be hard to determine since when the allocation key should be considered. OECD explains about it that "a difficulty arises because there can be a time lag between the time when expenses are incurred and the time when value is created, and it is sometimes difficult to decide which period's expenses should be used." (OECD, 2016, p.18)

Example of profit splits

Revenue profit split

In order to better explain what we have till now described, let's take a practical example.

As assumption, we can take a pharmaceutical group, and two subsidiaries within the group that co-promote drugs. To stay simple, just assume there are no royalty payments involved, so we are not in a licensing agreement as ruled by Goldscheider, the resale price approach is not applicable because we are talking about intangible assets and not about goods, and the co-promotion fee is established based on percentage of revenues of both parties. The reasoning underlying the choice of the revenue split takes into account three main pillars:

- In the industry, the cost of goods sold is variable, and between the parties is difficult to associate particular costs to the functions performed;
- Some capital costs like for example marketing and R&D costs are used to determine the split of revenue: analyzing this kind of costs, it follows that the share of R&D costs sustained this year will not reflect on the revenues of the same year;
- The case is complex, because the investment happens in stages.

Especially considering the last point, assume that company A performs R&D activities and Company B marketing activities. The co-promotion agreement is entered into after the R&D stage and before the marketing stage. In this case there is an issue related to the competence of the costs, so the question is: how should the historical costs of the R&D and projected costs of marketing be evaluated at the time of the agreement? Then the solution is to use the risk adjusted capital costs as allocation factors.

Gross profit split

This method works using the profit after deducting the cost of goods sold. The deduction of the costs is permanent even if third party agreements most often include clauses which allow renegotiation of the terms in specified conditions. This does not mean to retroactively adjust costs but just changing the wrong projections and allocation keys. In fact, if the costs were retroactively adjusted, the method would become a transactional net margin one. Regarding the possibility of changes, the allocation ratio may vary due to projections variations. Anyway, allocation factors should not be subjected to change.

Here below are the possible cases when renegotiation can be done:

- It is possible when there are changes in future revenues, costs and in projections of profit;
- When future transfer price is adjusted.

Operating profit split

The split of operating profit is generally done after deduction of variable costs and OPEX.

In this case, which ones should be rational allocation factors? The notional capital costs, adjusted for the risk, and the OPEX. About the first kind of costs OECD does not have a clear opinion, and the main reason consists on the possibility to legally shift the risks and the capital through the use of contracts. On the other hand, the use of OPEX as allocation factor is much more accepted and it is easier because the actual costs are reported in each entity. This way to allocate the costs has some pros and cons. One of the pros is represented by the effort of the OECD to pin down costs in order to quantify people function. This enables to consider the importance and the relevance of employees' role in the activities under examination. Then, another positive feature is the chance to analyze and to "break down" the indicator in two kinds of functions, and their costs related: routine and non-routine functions. The routine costs will be taken into account as allocation factors. The non-routine ones will be adjusted for the embedded risk. However, one of the cons is that the delineation of the risks associated with the expenditures is not clear. This last feature is so relevant that has as a consequence the ineffective usage of the OPEX as allocation factor, leading to the needed use of the notional capital costs.

Residual profit split

This is the last way to split profits, and it consists in the division of the part obtained after the deduction of variable costs, of the OPEX and after having allocated the routine returns. Is there any difference between the contribution profit split, described above? Well, theoretically there should be coincidence of the results if:

- Low risk capital costs, associated with routine functions and high risk capital costs, related this time to valuable intangible assets, are evaluated appropriately for the contribution analysis;
- The comparable selection for the routine return is appropriate and the high risk capital costs connected to valuable intangibles are evaluated appropriately for the residual profit analysis.

Summary of the method

After this brief description, it is appropriate and it is time to summarize the key points of the Transactional profit split method.

It is easier starting with the analysis of the strength's points.

First of all the method offers a reliable and valid pricing solution every time the actual transaction reflects the activities undertaken by two or more associated enterprises involving the sharing of economically significant risk. This happens most likely when within the group there is a high level of integrated operations and when they both contribute unique intangibles.

Secondly, it is definitely the best method when there are difficulties in finding proper comparable companies.

Thirdly, it is possible to slim down the list of the results to take into account, because the improbable outcomes of the method should not be considered. About this point, important to highlight is the fact that profits being divided are actual and they are not chosen from a benchmark. These are relevant key points for the choice of the method.

Moving on, there are some negative features, impossible to avoid.

On the top of the list there is the hard application of the method because of the barriers in accessing the data. We already described several times how this factor influenced the choice, since the first studies of Goldscheider.

Then, the approach required for the correctness of the results is transversal from the past till the expected expenditure relating to the combined profits from the transaction or transactions concerned. About this point, it is essential to keep in mind the importance of the assumptions needed before the study: it is fundamental to be aware of the business under focus, and a productive cooperation between the tax admin and the taxpayer is strongly recommended.

Further, and this point is linked to the first one, the profit split method is the worst one considering the time needed to get the data. It is a time consuming activity, and most of the times the data are never enough to perform a detailed analysis.

Moving forward, considering the nature of the profits taken, and agreeing about the use of the actual profits as more reliable, their analysis is much more complex and it requires an annual check on the changes in the business and in the transactions being priced. On the other hand, if the decision occurs on the anticipated profits the main risk to face involves the obsolescence. This may be seen also in the appropriateness of the supporting calculation needed, because several times there is no up to date adjustment in a dynamic business for example.

From a mere operating perspective, issues might arise while adjusting for the embedded risk in fixed costs and capital costs. The choice of the adjustments to be done may be highly subjective, depending on the circumstances. Then, tax authorities can easily attack the weighted allocation factors if there is no economic backup, and for this it is strongly advised to have economic studies to support the weighting of the allocation factors, and in this case proper documentation is required not accepting simple interviews with the management.

Summary

The aim of this chapter is enabling the reader to understand the method, its evolution, its variation and its pros and cons.
The first application of the method has been required fifty or sixty years ago while analyzing the licensing contracts ruling the use of patents and trademarks.
Nowadays there are also other reasons leading to the application of the method, mainly tax purposes, well explained in the double taxation problem arising from the transfer pricing application.
The Transactional profit split method is essentially the best one when the transactions under focus involve “unique” intangible assets for its ability to avoid the need of comparability, essential pillar of the transfer pricing policy indicated by the OECD, the one recognized all around the world.
It is undoubtedly the most difficult method to apply considering the hard research of the data and the peculiar identification of the kind of profit needed to use taking into account the specific case.
At the moment there are no other chances to use another method considering this type of situations even though the sharp critics to the decisions to be done while incurring in a serious transfer pricing issue as it happened the last August in the Apple case, involving Ireland, the EU and the United States.
The international commissions do not univocally agree on a way to adopt, because the theme is extremely complex, and it is not just related to international taxation whereas it considers also the national legislations of the host members. It is hard to say which one is the criterion to consider, if the revenues earned or the share of value effectively created (just think about the R&D of Apple based in California), and every country wants to get as much as it can.
The OECD guidelines try to give some insights to the companies and to the tax administrations in order to mediate between them and to easily cooperate. Unfortunately, it is a long way to find the optimal solution to this sharp problem.

Case study: residual profit split application

This chapter analyzes how to apply transfer pricing method. In particular, considering our object has always been a MNE where two or more associated companies located in different countries make some valuable contributions to intangibles, the case will be developed according to the Residual profit split approach.

We have already raised several concerns during the dissertation about the application of this method, with the specific reference to the OECD 2010 Guidelines. What we did not fully described is the attitude of the different Tax administration of the Countries hosting the branches.

To make it simple, we will assume that the Parent company will be an Italian one, and the Tax administration point of view about we will go through right now is the one of "Agenzia dell'Entrate", the main Tax institution in Italy. Since this moment we will call it "AE".

According to the OECD Guidelines, there is an order to respect in the case of application of the methods. Usually the first thing to do while performing a TP analysis is always looking for reliable benchmarks, trying to understand what they do and to perform a CUP analysis. Obviously, it is the easiest way, it is the most objective one and it ensures a fair treatment by the Tax administration, that it may not adopt different kind of analysis than the one performed for the comparable company. AE it is not different in this sense, and it never really appreciated the Profit split, judging it too much discretional. This is undoubtedly true, if we consider the exchange of something physical among the group. For what concerns the exchange of intellectual property, the matter is much more complicated.

About this topic, recently, the AE, issued a measure called "Patent Box" with the aim of covering the lacks in the legislation about the taxation of IP. The measure of which we are talking about is the "Circolare n.11 of 2016".

This covers the definition of IP, aiming at describing what really IP is and what is not, and how to deal with transactions involving exchange of intangibles. The aim of this Patent Box, issued after the BEPS, already described in the previous chapter, is to measure the exchange of intangibles through transfer pricing, and trying to make a favorable treatment to the companies involved in this kind of transactions to fight the possibility of elusive behavior. The companies we are describing are the ones based on high valuable intangible.

The AE, as the OECD, advises the performance of a functional analysis as starting point to delineate the business functions that create value, how and how much, leading to a division of tasks between the different functional business units or, in the case of a large MNE, between the different operative branches.

Most often the role of the functional analysis is underestimated, considering it as a non-primary activity, performed only after the attempt to find a correct comparable. This is wrong, because it is important to understand the Company, the business, the role of the functions, the structure, the budget available to each of them, the synergies among the group. Avoiding this process is non-sense, especially while trying to isolate the effect of the different functions and assets to correctly find the share of income arising from a particular intangible.

The case we will go through now is well structured and in compliance with what we just described.

The case

Let's take a Group named Alpha, operating in the sport accessories for alpinism industry. The group produces, sells and it projects the products. It is not too big, and it is new in the market.

The Group is divided in three companies, the parent and the branches. The parent is the heart of the Group, who performs the most valuable activities like R&D and Marketing for the brand. Then there are the two operative branches: a productive one located in Eastern Europe called P and one devoted to the distribution, located in Switzerland, called D. The financial statements we are going to analyze are related to the financial position of the Group.

Our approach consists, according to the profit split theory and to the last decree issued by the AE, to divide income statement for functions. Proceeding in this way, our aim is to isolate the effect of the intangible, being able to understand the real incidence it has on the business cycle. Dividing the income statement for functions implies the adoption of benchmarks to get a reliable estimate of some items, like revenues given by the only production activity, like the royalties to apply to the intangible under discussion.

This approach considers every function of the group as each independent company operating in its own market and it earns income or loss like every other one. This maybe might appear as an unsophisticated view of the company's complexity, whereas the reality is slightly different.

Identifying the business unit, analyzing the potential, the features, the products, the market it is everything but simple. Here we are overcoming this hard step of the work because we should have the chance to access to company's data that are not available for disclosure. In particular, a lot of studies have to be performed before delineating the proper benchmark for the business unit. We can anyway consider it as given.

We have already highlighted that generally the profit split is the last method to apply following the hierarchical order suggested by the OECD and by the AE. This is mainly due to the strategic importance of the comparability analysis regarding the transfer pricing matters. The profit split overcomes the need of comparable companies but this does not mean that, actually, there is an attempt with this method too to find a sort of "comparability". It is always difficult to split a company in different pieces, usually called business units, or in our case, as structured previously, in branches. After this brief summary, we can say we suppose we have identified some benchmarks for what concerns the productive and distributive function. This is basically done referring to the Italian market but we have enough elements to state it would not be slightly different if referring to a bigger market ceteris paribus. The data will be annexed to the graph below.

5.1 Financial statements of Alpha

Amounts in M Euro	Drivers	Amount	Function	% on sales
Sales		**91.484,85**		**100%**
Raw Materials		-30.791,62		-33,66%
External Labor		-24.158,18		-26,41%
Internal production		- 5.265,91		-5,76%
Delta Inventory		758,88		0,83%
Industrial Margin		**32.028,02**		**35,01%**
Commercial variable costs	A	- 3230,82		-3,53%
Contribution Margin		**28.797,20**		**31,48%**
Industrial fixed costs	b	- 1.347,57		-1,47%
R&D-production	b	- 1.601,46		-1,75%
R&D-Design	d	- 786,78		-0,86%
R&D-Patents	d	- 46,33		-0,05%
Fixed commercial costs	a	- 3.889,26		-4,25%
Marketing & Communication	d	- 5.621,85		-6,15%
General Administrative Expenses		- 8.308,62		-9,08%
EBIT		**7.195,33**		**7,87%**
Financial Income and Losses	a	- 1.640,70		-1,79%
EBT		**5.554,63**		**6,07%**
Taxes		- 1.499,75		-1,64%

NET INCOME	**4.054,88**	**4,43%**

This is the Consolidate Income Statement of the Group and as you see there are some notes like "a, b, c, d" where they indicate their affection on the revenues, costs and intangible side. They are indicated as drivers which help the allocation of costs.

Under the column function on the other hand there is the connection of the items to the correct function. With D we indicate the distributive function, with P the productive one and with IP BOX we refer to the items candidate for the allocation to the intangible side.

The numbers expressed in percentage represent the incidence on sales.

The most important indicator for our purpose is the EBIT that is 8% on the revenues. Between the contribution margin and the EBIT there is room to identify the incidence of the intangible on sales. Doing in this way the company may understand the real power of its intangible and in compliance with the Patent Box may receive a tax benefit. Considering there is a huge gap between the two indexes, we can move on the division according to the functional analysis.

5.2 Financial statement of P

Amounts in M Euro	Drivers		Amount	% on sales
Figurative sales			**69.282,78**	**100,00%**
Raw Materials		-	30.791,62	-44,44%
External Labor		-	24.158,18	-34,87%
Internal production		-	5.265,91	-7,60%
Contribution Margin			**9.067,07**	**13,09%**
Industrial fixed costs	b	-	1.347,57	-1,95%
R&D-production	b	-	1.601,46	-2,31%
General Administrative Expenses	b	-	5000,00	-7,22%
EBIT			**1118,04**	**1,61%**

As we see on the first row of the table there is an item called "figurative sales". Figurative because they are not real, but they are based on a hypothetical benchmark that consists in about 2% of the EBIT on the sales based on the competitors.

As you can notice then, the expenses are exactly the ones in the consolidate statement, because it is the productive phase that needs the raw materials and the labor costs. Then, we need to consider the costs allocated to the specific business unit.

5.3 Financial statement of D

Amounts in M Euro	Drivers	Amount	% on sales
Sales		**91.484,85**	**100%**
Cost of commercialized products		- 69.282,78	-75,73%
Delta Inventory		758,88	0,83%
Industrial Margin		**22.960,95**	**25,10%**
Commercial variable costs	a	- 3.230,82	-3,53%
Contribution margin		**19.730,13**	21,57%
Commercial fixed costs	a	- 3.889,26	-4,25%
General administrative costs	c	- 3000,00	-3,28%
Figurative royalties		- 12.056,99	-13,18%
EBIT		**783,88**	**0,86%**

This is the income statement regarding the distribution function, in our case of the company D.
The sales are exactly the ones accounted for the consolidate income, because it is from the distribution activity the earnings in terms of sales. The costs are the ones accounted as sales for the productive functions, representing the cost of goods sold. Then, same reasoning for what concerns the allocation of the costs as indicated above.
The figurative royalties is an item needed and in line with the competitors to make real and reasonable the activity conducted. The same reasoning as explained above, to be compliant with the competitors, the benchmark was around 1% of the EBIT on sales.
What is missing now is the part related to the intangible side.

5.4 Financial statement related to the IP BOX

Amounts in M euro	Amounts	% on sales
Figurative revenues from IP BOX	**12.056,99**	**100,00%**
R&D-Design	-786,78	-6,53%
R&D-Patents	-46,33	-0,38%
Marketing & communication	-5.621,85	-46,63%
General administrative expenses	- 308,62	-2,56%
EBIT	**5.293,41**	**43,90%**
financial interests	- 160,71	-1,33%
EBT	**5.132,70**	**42,57%**
Taxes	-1077,82	-8,94%
Net income	**3.696,75**	**33,63%**

This last table highlights the incidence of the intangible asset on sales, almost 34%, and this is indicative of how much is worth it. As you see, we took the figurative royalties as revenues of the parent company, and all the items associated to the development of the intangible.

The net income is exactly the one we found out on the consolidate statement.

Explanation and critics

The case is realistic and it is quite easy to understand.

We have supposed a Group really well divided, where the branches have a unique role, similar to a business unit. This is a strong assumption, but fundamental for our purpose.

The location of the productive branch in the Eastern Europe is strategic and in line with the behavior of the companies nowadays, where generally they prefer to spend less money on the labor cost. The benchmark used for the productive branch should have been based in comparison to other low-labor cost countries to be really precise, but the data available did not allow us to do that. We have already said that for our purpose the benchmark is appropriate and it is not subjected to huge differences.

The location of the distributive one is strategic too, considering Switzerland is one of the most expensive countries in Europe, it is recognized as a tax haven, and due to the big purchase power of the Country it is possible to charge the customers with prices higher than the normal. Many companies and normal citizens go to Switzerland for its favorable tax regime.

Given the circumstances and having clear in mind the environment where the Group operates, the following questions arise: is it the correct approach the one adopted? Is the approach correct in its application?

These two questions will be the objects of our analysis.

About the first question I would say the answer is yes.

The following elements motivate the answer. Consider in fact the nature of this group, the market where it operates and the real source of power of the company. It is a small group trying to grow, where it operates in a market not so crowded. The strength of Alpha is the reputation of its products, their robustness, their safety and their nice design. This is mainly due to heavy investments in R&D and in a continuous research of the design's perfection, i.e. in what we would define IP. This makes Alpha a powerful company in the market, and it is new, and the possibility of expansion is high. All these features imply that Alpha does not have proper comparable companies. It follows the exclusion of the possibility to deal with the CUP, because there are no comparable companies and transactions. The other methods are not taken in consideration because they are not provided being in line with the Patent box.

These are convincing elements and they encourage the use of the profit split.

However, the theory would take into account also the nature of intangible's exchanges. The OECD states in fact that the profit split should be used when the parties co-operate with valuable contribution to the intangible. In this case, there is no real exchange of intangible across the countries and there is no cooperation among the group in development of the asset. This is concentrated in the Headquarter located in Italy, there is no sharing of know-how and there is no valuable contribution from the branches. This is a fundamental imperfection in the application of the method. The only reasoning we may make in this site is that, anyway, the profit split was the only one, ceteris paribus, allowed to be used.

Moving forward to the second question, about the correctness of the approach, these are my considerations.

First of all, the mandatory steps like the comprehension of the business, the study of the company, the identification of comparable companies regarding the productive and distributive function have been fulfilled. As we have already mentioned, the functional analysis is the most important step in the preliminary activity. Afterwards, the division of the consolidate income statement, the use of figurative items to make the analysis comparable, have completed the task leading to three plausible income statements for three different companies that transfer goods, services and intangibles each other.

In my modest opinion, there was no other chance to apply this method but in this way given the conditions.

However, following the guidelines and the literature, the split should be based on the percentage on R&D investments or on other criteria decided upfront, or at least, well identified afterwards. It is still hard to identify who makes what, in which share and what it earns, but this is the theory of the method. In this case none of them is present. The development of the intangible is job of the parent company, the branches are just mere “arms” to operate, but they do not contribute in any way to the addition of the real value, here represented by the brand and by the design of the products. Here as above, some doubts may arise regarding the right application of the method.

However, the application is correct in these circumstances. In line with the patent box, the method enabled to identify the share of income generated by the intangible. It does not really matter if this share has been generated through international exchanges or just nationally. The patent box provides the adoption of a favorable treatment towards the companies based on high valuable intangibles. The reason is simple: to stop somehow the great exchange of these years in terms of transfer pricing, to ensure to Italy the correct amount of taxable income that through the use of transfer pricing is somehow in danger. The patent box allows the application of the residual profit split as advised by the OECD also in this case and it follows that the approach, even though missing an important pillar as it is the co-operation agreement between the parties, it is the right one and it has been correctly performed.

Conclusions

Almost at the end of our trip throughout the complex and fascinating world of the transfer pricing, it is time to summarize and to conclude with our considerations about the exchange of intangibles in particular.

The first concept we have analyzed has been the mysterious and ethical arm's length principle. The assumption regarding the companies fairly competing without guidelines is not realistic, but the strong controls by the tax administrations are forcing a greater attention by the companies to be compliant with the rules, or at least to not be punished. Trying to respect them many factors have to be taken into account, like the market, the products, the changes in the law, simply speaking, the performance of a functional analysis. As we have seen in the last chapter too, is simply fundamental in order to correctly apply the methods provided by the OECD.

These methods have been described in the second chapter with the purpose of an overview on the possibilities given by the OECD. Every method has its own characteristics and its own environment where it is the preferred one. These are just strongly advised and they are useful for the tax administration to check if the companies are transferring goods and services at a market price. The companies may choose to use the tools available for their intercompany exchanges. Sure it is, if they do that, it is less risky from a fiscal point of view.

After having analyzed the advantages and disadvantages of each method, a great focus has been given to the concept of intangible. The definition given by the IAS 38 and the studies on its properties and on its difficult valuation just helped us to introduce the hard challenge in selecting the right method while intangibles are involved and there are no comparable enterprises. While describing the features of these powerful assets a probable application of the Transfer pricing methods has been simulated leading to a conclusion: the profit split method is the best one while dealing with unique intangible. It is important to remind anyway the more frequent use of an agreement called CCA: cost contribution arrangement. It is clear, fair and easy to apply. This will be probably the future of the international transactions inter-company.

In the end, the last theoretical chapter deeply described the Profit Split method. Since the 50s several studies have been conducted in order to ensure a right valuation of IP exchange through royalties. Goldscheider started with the famous rule of thumb, which convinced for almost half a century. By the way, the Uniloc case changed the way of setting the prices of royalties: it shed the lights on the need of valuing case-by-case, keeping in mind the specific features of the companies and of the assets under focus. It has been the first real change about this topic and it led to great changes in evaluation of royalties. The principle of 25/75 was not wrong but it was too simple, avoiding whatever kind of analysis needed on this topic. However, the split confirmed to be the most reasonable thing to do, but decided upfront based on specific data.

The exchange of intangibles is one of the most complex topics in accounting and in international taxation, and it is the reason why so many Countries dispute between them. The crowded flow of international transactions, the non-stop offshoring of big companies to Ireland, Cayman Island and to all these other tax-free countries are just warnings of what the tax administration commonly call "fiscal evasion". We have tried during this dissertation to find the correct balance and the methods to ensure as far as it is possible the transactions at "arm's length" but what is clear is the different challenge while transferring a physical good instead of an intangible asset. The speculations, the hard valuation of the intangible assets also referring to the IAS, the more complex legislations and great sophistications of the international trade make the transfer of intangibles a matter of undeniable difficulty. Anyway, what we can conclude is that, with these tools available, probably the profit split is the best weapon to fight the illicit and unfair international intangible exchange. The patent box and the provision of the profit split is just a proof of how the Countries care about the problem, giving incentives to the companies to a fair trade in exchange of fair prices. There is no doubt the reason behind is just referred to the taxation of a higher share of income, but concluding with a famous sentence, "it's all about money".

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