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Contents

Editorial

INTERNATIONAL TAX REVIEW

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Introduction

Dear readers,

The global transfer pricing practice of Deloitte Touche Tohmatsu Limited is pleased to present the 2013 edition of *International Tax Review*'s Intangibles guide, a collection of articles on different aspects of transfer pricing for intangibles or intellectual property.

In 2013, issues relating to the transfer pricing of intangibles continued to dominate the tax landscape, and much of the discussion was driven by the OECD's release in February of a report on base erosion and profit shifting (BEPS), followed by an action plan on July 19. The action plan identified 15 specific areas for further work , one of which specifically calls for "ensuring that profits from intangibles are not divorced from value creation and special measures for hard-to-value intangibles". The OECD again took centre stage on July 30 when it issued a revised Discussion Draft on Transfer Pricing of Intangibles for public consultation.

But all the discussion has not necessarily resulted in consensus, and questions regarding both broad policy issues as well as the nitty-gritty of the taxation of intangibles still abound. In this guide, we deal with both.

Our piece on the convergence of tax and operational factors in intellectual property planning surveys the OECD intangibles initiatives, and one of the lessons it distills is that operational substance has become the lynchpin of successful IP planning. Reaping the benefits of an IP tax structure will depend, to a great extent, on the ability to put operational substance into the legal entity that owns the IP.

While many intangibles issues span across industries, some are particular to specific sectors. In this guide, we include two articles that address these issues as they affect two industries. The first discusses the transfer pricing of intangibles in the media and entertainment sector, which is evolving from a primarily US-centric industry to a globalised one. Thanks to new production technologies, increasing digitalisation of content, and globalisation, production costs and barriers to entry are declining. The challenge for many established companies will be to effectively manage intangible assets when these are created in a decentralised manner across the globe.

Our second industry-specific article provides a framework for identifying the economic or beneficial owner of intangible property, and illustrates its use in a case study of a hypothetical life sciences company.

To lay people, it may come as a surprise that after so many years of debate on the proper way to tax intangibles, so much remains unsettled. One of the reasons for this is that as new industries and business models develop, the old answers may not be a good fit. Case in point – the cloud computing industry. A few years ago, very few people would have known what the cloud is; if you're still not sure what it is, read our article on the subject – it will bring you up to speed.

The same can be said for procurement – it is only in recent years that this business discipline has emerged as a field in its own right, and one that is expected to bring value to the organisation through cost savings. We include an article that explores both the opportunities and the process for procurement functions, tax departments, and other stakeholders in an organization, to collaborate to capture the full value created from the evolution of the procurement function.

Unlike the big picture articles already mentioned, the next two delve into the fine points of intangibles taxation. The first of these two provides an overview of acquisition premiums from a transfer pricing perspective in the context of a cost sharing analysis. The second presents a venture valuation model.

Even though the final US cost sharing regulations were issued in 2011, questions continue to arise. Since the introduction of those regulations, which included a set of "commensurate with income" rules, tax practitioners and commentators have raised concerns that the new CWI rules could conflict with the arm's-length standard. The article provides a general conceptual framework to discuss how different valuation methods relate to CWI rules, and demonstrates that a variant of a specific valuation approach, the venture-valuation model, can resolve some of the challenges that arise in the context of applying CWI rules.

The issues that arise from the transfer pricing of intangibles are almost by definition cross-border – taxpayers and tax authorities across the globe are grappling with the same issues. But sometimes, questions arise that affect specific countries in particular. That is the case with location-specific advantages, the notion that unique market features deserve separate recognition and compensation through appropriate transfer prices. China and India in particular have been vehement proponents of the idea that a portion of any LSAs should accrue to the local entity and be subject to tax in that country, although neither country has yet come up with a systematic approach to identify and quantify LSAs. Our article on LSAs provides an overview of the subject, and makes some predictions for the future.

Navigating the world of transfer pricing of intangibles is not easy; for assistance in this endeavor, please contact your local Deloitte transfer pricing specialist.

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Business Model Optimisation – Co-Global Leader

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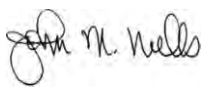

John Wells
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IP: Converging tax, regulatory, and operational factors

Effective intellectual property (IP) tax planning is increasingly dependent on the convergence of political, regulatory, and operational factors. David Cordova, Michael Bowes, J. Donald Fancher, John A. Hudson, and Sam Chung discuss.

As a policy matter, some aspects of traditional IP tax planning have come under increasing scrutiny by local governments and the broader international community, which may have an impact on the parameters of effective IP tax planning. Meanwhile, profit drivers associated with IP continue to evolve from classic brand and technology-oriented assets, as personal services-oriented assets such as trade secrets, know-how, and data analytics provide tax departments both an opportunity and an obligation to work closely with business leaders to craft sustainable IP tax planning structures.

What is IP and what is its significance to tax planning?

Before a discussion of the evolving IP and IP tax planning landscape, an overview of the concept of IP and its potential relevance to a business enterprise's tax planning is necessary.

What is IP – a business executive's view

Intellectual property is often viewed differently by different people. The traditional view of IP includes assets such as patents, trademarks, brands, and copyrights – all assets that are usually registered and/or published, and are protected through various statutes, laws, and treaties by governments around the world.

IP also includes trade secrets – the nonpublished and protected capabilities, designs, or formulas of companies or individuals that are closely held and maintained by the organisation. Each of these components of IP has a potential for great value that must be considered by executives, business leaders, and tax professionals. In fact, workaday know-how – the experience an executive or a workforce has in getting the job done – can often qualify as the most important IP asset within many companies. Understanding these categories, along with other forms of IP, is important when preparing plans to measure, protect, and profit from the intangible assets within an organisation.

IP is not a static commodity. The role it plays, the costs it imposes, the benefits it offers, and the associated risks – all change over its lifespan. IP may enter an organisation at the moment of its invention, as a result of a joint venture agreement or partnership, or as a direct purchase via an acquisition that includes IP assets. Like other assets, the value of IP can depreciate over time without appropriate investments, although calculating that value erosion is not always as clear cut as with a tangible investment. In the end, an organisation can retire an IP asset, much like it would a building or a piece of equipment. For example, IP can become obsolete as technologies advance or change. The concept of the IP lifecycle is significant because it adds a time dimension to the way an organisation considers and manages its IP assets. This is not a decision an organisation makes once, but a long-term

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David Cordova
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David Cordova is a tax partner in Deloitte Tax with more than 25 years of experience specializing in providing international tax services to multinational companies ranging from startups to Fortune 100 companies. He has extensive cross-border tax experience, as well as in international mergers and acquisitions, structuring foreign operations, and negotiations with tax authorities. He is one of Deloitte's global specialists in international accounting for income tax.

Mr Cordova serves as a member of Deloitte's Business Model Optimisation leadership team, and has many years of practical experience working with clients in intangible-oriented industries such as technology and consumer businesses. He recently returned to the United States after having served as Deloitte's Clients and Markets leader for the Asia Pacific tax practice, based in Tokyo.

Mr Cordova is a graduate of the University of Washington, from which he holds a BA in Accounting, as well as the Denver University Graduate Tax Program. He is a member of the American Institute of Certified Public Accountants.

strategic plan that requires foresight, agility, and constant evaluation.

What is IP – a tax professional's view

There are many different definitions of IP. For example, there are different definitions for accounting, legal, and tax purposes, to name just a few. And these definitions may differ depending on what jurisdictions a multinational enterprise operates in.

The US transfer pricing regulations, under section 482 of the Internal Revenue Code, define an intangible (a term that is broader than traditional intellectual property) as an asset that comprises any of the following items and has substantial value independent of the services of any individual:

- Patents, inventions, formulae, processes, designs, patterns, or know-how;
- Copyrights and literary, musical, or artistic compositions;
- Trademarks, trade names, or brand names;
- Franchises, licenses, or contracts; and
- Methods, programmes, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data.

The OECD, recognising that varying definitions exist, has taken a broader approach, defining intangibles as either marketing intangibles or trade intangibles. A marketing intangible is an asset used in business operations that is customer facing (trademarks, trade names, customer lists, customer relationships, etcetera). Trade intangibles are commercial assets other than a marketing intangible.

The OECD provides the following examples of its broad definition, although the OECD states that these are not intended to be comprehensive or to provide a complete list:

- Patents;
- Know-how and trade secrets;
- Trademarks, trade names, and brands;
- Rights under contracts and government licenses;
- Licenses and similar limited rights in intangibles; and
- Goodwill and ongoing concern value.

There is considerable overlap between the OECD's examples and the US transfer pricing definition, with one notable difference: the OECD treats goodwill and going concern as intangibles. The OECD believes goodwill and going concern cannot be separated from other assets within a firm; as a result, a significant part of the payment for IP transfers among third parties may reflect goodwill and going concern value. Thus, such value should be taken into account when valuing related-party transfers. It is worth noting, however, that proposed international tax reform measures in the US, if enacted, could expand the scope of the definition of intangibles to include goodwill, going concern, or workforce in place.

Evolution of IP tax planning

Many readers will be familiar with the idea of foreign-based corporations, usually organised in tax-efficient jurisdictions aided by rulings that facilitate base erosion, that participate in arrangements to share in the cost of developing IP, and in turn reap the potential upside benefits of such IP. Tax-related IP planning has captured a significant amount of attention lately from the OECD, as evidenced by Working Party No 6's study on intangibles and the base erosion and profit shifting (BEPS) project. The upshot of these initiatives is that substance in the IP holding company is of increasing interest.

The basic principle behind IP tax planning is that business enterprises can reduce their global tax burden by earning the profits attributable to IP in low-tax jurisdictions. The profits attributable to IP can be captured by having the IP owner utilise the IP, license rights to others (related or unrelated parties), or sell the IP.

Sustaining the benefits of an IP tax structure depends critically on the firm's ability to put operational substance into the legal entity that owns the IP. Stated differently, success depends on the firm's ability to align the business model with

the IP structure. According to the OECD's discussion draft on intangibles, if the legal IP owner is to be entitled to all residual IP profit, then it must perform the functions related to developing, enhancing, maintaining, and protecting the intangibles – or it must arrange to have such functions performed under its control by related or unrelated parties. Naked IP structures that have little operational substance yet capture all the residual IP profit are therefore susceptible to challenge under OECD guidance.

Traditional tax structures, whereby the IP is centrally located at the parent company, are also susceptible to challenge if the business model is not aligned with the structure. For example, under OECD guidance, if the IP owner (the parent company) outsources key operational substance to related parties, and those parties have significant control over their activities, then the entity performing the outsourced activity is entitled to a portion of the profits attributable to the IP. Many early-stage multinational enterprises that have centralised their IP at the parent company treat offshore affiliates as routine service providers that earn limited-risk returns. Under OECD guidance, those entities may be entitled to a portion of the residual IP profit to the extent they exert significant control over their activities.

In Europe, the US, and other locations, headlines highlighting claims of international corporate tax abuses have become common. The general theme of these claims is a perceived lack of actual substance in the pertinent jurisdiction. Frequently, these stories are not even covering the extreme cases – such as a post office box in Bermuda or the Cayman Islands supporting an offshore paper company. More often, they discuss companies in jurisdictions in Europe or Asia where a multinational enterprise has actual operations that involve personnel and sometimes manufacturing. These claims highlight a tax fairness policy debate that has become more relevant as nations experience credit defaults and the resulting austerity measures to combat economic recession.

While the end result of calls for international tax reform remains uncertain, the trend for the evolution of IP tax planning is clear: business operational substance should be supportive of IP tax planning. This means tax departments must connect with business leaders to stay abreast of IP initiatives and development, and propose and maintain structures that are fluid and capable of responding to developments in a timely manner.

The consequence of not staying informed is that IP strategy and business operations may not be aligned, potentially leading to:

- Income generation in entities that lack substance;
- Operational challenges when a tax structure does not support operations, often resulting in excessive operating costs and/or tax risks such as the creation of a permanent establishment, or the application of subpart F in the US;
- Poorly structured IP asset management leading to profits build-up in high-tax jurisdictions;
- M&A activity that leaves IP assets in entities or jurisdictions where owning it costs too much and/or too little value is realised; and
- Poor planning related to IP management and IP capabilities, or poor documentation of the IP inventory and its use, thus inviting regulatory challenges.

The result can be not only a higher global tax burden, but also limited ability to make effective critical business decisions on an after-tax basis.

IP tax planning today – what does it all mean?

The definition of IP for tax purposes is broad and may include items not traditionally considered intangibles. Before engaging in IP tax planning, business enterprises should take stock of their intellectual assets, cataloging and documenting the following to avoid unnecessary challenges by the tax authorities:

1) IP the firm owns (both acquired and developed, legally protected and not);
2) IP that is licensed in or licensed out;

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Michael is Deloitte's national technology co-leader for the US transfer pricing practice. He has more than 13 years' experience consulting on transfer pricing and tax issues for several of the world's largest technology companies, providing valuation and economic consulting services involving mergers and acquisitions, international tax planning, and the restructuring and reorganisation of international operations. He has negotiated US and foreign advance pricing agreements, managed US and foreign transfer pricing audits, and met with various competent authorities on behalf of his clients.

Michael is based out of Deloitte's Silicon Valley office in San Jose, California, where he directs a team of more than 25 transfer pricing analysts across the Pacific Northwest.

Before joining Deloitte Tax, Michael was an economist with another Big 4 firm, an economist with Christensen Associates, and a graduate teaching fellow at the University of Oregon in the economics department.

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Don Fancher is a principal of Deloitte Financial Advisory Services (Deloitte FAS) and also serves as the national leader for Deloitte FAS' IP practice. Fancher has over 25 years of experience assisting clients and leading practices in forensic and dispute consulting, having served in a variety of geographic and practice area leadership roles. Fancher has demonstrated expertise working domestically and internationally on client service matters regarding forensic investigations, dispute consulting, IP litigation and reorganisation services across a number of industries, and has testified as an expert on numerous occasions in federal, state and bankruptcy court.

Fancher has provided consulting services in a variety of matters regarding the assessment and evaluation of IP portfolios to assist clients in the management of technology and intangible assets. He has provided assistance in licensing negotiations, technology and IP valuation, market and industry assessments, and IP portfolio management. He has also provided commercialisation, monetisation and business and IP strategy assistance to clients. These efforts have included performing analyses such as business and product planning, market studies, valuation, financial proformas, profit projections, and overall IP strategy plans and assessments.

Fancher has also evaluated and provided expert testimony in relation to various disputes for patent, copyright, trademark, and trade name infringement, as well as trade secret misappropriation. He has quantified damages analyses that include the calculation of lost profits, the determination of reasonable royalties and hypothetical negotiation scenarios, the quantification of unjust enrichment, and the assessment of the economic value of IP. Fancher has also testified in numerous commercial litigation and class-action matters and his testimony has been provided in Federal, State, and Bankruptcy court cases.

Fancher's clients include Fortune 500 companies, universities and research organisations, government departments and labs, early stage development entities and IP investment organisations. Industries served include technology, telecommunications, energy and petrochemical, life sciences, medical technology and biotechnology, consumer products, manufacturing, computer hardware and software, and others. He has also authored and delivered numerous publications and presentations regarding damages, IP, and forensic issues.

Fancher holds a BBA in Finance from Texas A&M University and a MBA from Baylor University.

3) Which legal entity owns the assets, legally and/or economically; and
4) Which entity or entities have responsibility for the development, enhancement, maintenance, and protection of those assets, and whether those entities have operational control over their activities.

A company's failure to document its IP holdings and align its existing (or future) tax structure to its business model may result in unnecessary risks. The taxing authorities will be only too happy to adopt their version of what IP exists and how that IP should be valued – and the applicable rules change frequently. The company that fails to identify, value, and strategically align its IP within the supply chain opens itself up to either excess risk and/or the failure to extract value from these assets. To take advantage of the potential IP that assets create long-term, a company's IP strategy must include components of proper tax planning and direct alignment to overall corporate business strategy.

Beyond patents, tax, and government reform: Integration of IP tax and business planning

Most multinationals understand that effective tax planning can enhance the financial benefits derived from IP. What may not be as well established or developed is how IP itself may be an undermonetised asset. Companies spend years, internal and external resources, and financial resources developing and purchasing IP assets, with the goal of having large IP portfolios to control. Today, what matters is not the number of IP assets a company owns, but the return on investment related to those IP assets. So IP owners are assessing what IP assets they need, which are core assets and non-core assets, and what might be the monetisation strategies for their specific set of circumstances. For example, value extraction strategic options include:

- divesting non-core IP assets;
- outlicensing IP to different industry verticals;
- forming joint ventures to further develop orphaned technologies/IP; and
- developing and implementing enforcement licensing for assets being used without proper authorisation.

Let's now look at how the convergence of tax structuring and increasing business value associated with IP come together in various scenarios. IP owners have evaluated the benefits of establishing IP holding companies for years. Similar considerations inform the strategic choice of centralisation or decentralisation of IP management and IP structures. With choices like this come the decisions to license-in or purchase IP in certain jurisdictions and by specific legal entities, or have all those decisions default to one centralised entity or holding company in a beneficial tax jurisdiction. Other structuring considerations exist, but those should be evaluated on a case-by-case basis.

M&A activity

When two organisations merge together, many parts must mesh, and the longer that integration process takes, the less effective the deal may be from a shareholder value perspective. It is not surprising that in such deals many leaders focus their attention on the tangible assets, working to integrate people and talent efficiently. A merger or acquisition also has the effect of potentially forcing two separate IP regimes to evolve into one go-forward strategy. If the resulting IP structure does not receive deliberate attention, it may be haphazard or even create less value than the status quo. It might not support the tax planning and business strategies that brought the entities together in the first place, and it might become locked into place over time.

If handled properly, the integration of IP assets and IP capabilities post-merger can provide significant benefits both in the near and long terms. The new entity has the ability to have IP assets in the right jurisdictions and entities, so that these assets can help generate value, and there will be a clear understanding of the potential tax implications. This will confirm that the location – both in terms of jurisdiction and/or legal entity – and utility of the IP assets will be aligned with the organisation's operating and enterprise resource planning (ERP) structure.

Conversely, if handled poorly, post-M&A IP strategy could enhance risk, decrease efficiency, contain redundancies, increase costs, and elevate the global tax burden. There are decisions in the integration process that an entity gets to make only once – and if an inefficient IP strategy is baked into the deal, it may be difficult to overcome in the future.

In an M&A transaction, IP tax, legal, and business planning must be front and centre – not only in integration, but as part of the transaction due diligence process. IP assets and related IP considerations are most likely major factors in the overall transaction, and therefore must be given the proper attention.

Mergers and acquisitions can challenge a company's strategy by adding new IP assets, new IP initiatives, and new structures into the mix – at various points in their lifecycles, and in ways that seldom align with the strategic decisions that already govern other intangibles. Thus, assessing the potential value of the IP assets, analysing the associated risks, and quantifying the opportunities the assets represent are critical factors. There will always be plenty of work to do during post-merger integration, but ideally the important IP strategic decisions will be evaluated and assessed during due diligence and contribute to critical transaction-related decisions before the transaction closes.

Company systems changes

Whether it's an update or an overhaul, a revamped ERP system will fundamentally alter the way a supply chain moves through an organisation. If a company's IP tax strategy is not aligned with changes to its supply chain, this could result in undesirable tax consequences due to such a misalignment.

As far as supply chains are concerned, businesses need to apply a tremendous amount of transfer pricing logic to the design of their business processes. That means knowing the rules of the road in and among the jurisdictions where the business operates. For example: who owns the IP, how does the IP drive value, which entity posts the profits, and how aggressive are the relevant taxing jurisdictions involved?

Biography

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Hudson is a senior manager in Deloitte Financial Advisory Services (Deloitte FAS) and supports Deloitte FAS' national valuation and intellectual property (IP) practice areas. He has more than 15 years of experience valuing businesses and intangible assets, and providing dispute resolution and investigation services in the Americas and Europe. Hudson has extensive experience in the analysis, diligence, valuation and value extraction strategies of all forms of IP. He has performed a variety of IP-related engagements including valuation and strategy issues related to technology and IP, IP contracts and related analyses and investigations, IP dispute/litigation consulting, licensee identification and license negotiations support, the evaluation of internal intellectual asset and intellectual property management programmes, and technology transfers transactions.

Hudson spends the majority of his time assisting clients develop and implement IP value extraction strategies. These strategies include strategic and enforcement licensing programmes, cross-licensing, divesting of IP portfolios, cost savings via abandonment programmes, and litigation. These engagements have been in the context of mergers and acquisitions, restructuring, divesture, arbitration, mediation, litigation, securitisations, investigations, tax planning, joint venture formation and spinouts.

In addition, Hudson has performed these engagements across various industries and sectors, and for clients that include Fortune 500 companies, universities, private companies, governmental agencies, not-for-profit groups, and individual inventors. Hudson often speaks on the topic of IP valuation, IP value extraction strategies and intellectual asset/property management.

Hudson holds a Bachelor of Arts in Economics from the University of Florida.

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Sam has a JD from the University of Washington and an LL.M. in taxation from New York University.

When an ERP project takes IP into account, people ask these questions early in the process and build the answers into the logic of the new system. At a minimum, that adds clarity that can help ward off excess taxation and risk. However, the potential benefits do not stop there, as building in sound IP components to an ERP change can identify areas of opportunity as well.

As with the "garbage in garbage out" principle of information systems, an ERP structure that does not have an IP strategy baked in may end up generating results that are inconsistent with industry IP leading practices. A company's risk will most likely go up as different governments compete for the company's tax dollars, and if the company doesn't have the proper documentation to sort out the potential liability this may create unmanageable risk.

When related parts of a business use each other's resources, tax authorities expect them to charge each other as if they were separate companies operating at arm's-length. Failure to plan effectively can lead to significant tax liabilities and risks of double taxation. Anticipating and easing the transfer pricing obligation starts with understanding the way different parts of a business relate to one another legally and the ways in which ownership of the relevant IP assets are parceled out.

For example, a business unit in one country may perform manufacturing functions for a business unit in another country that imports the goods and sells them. The plans and specifications, technical trade secrets, and know-how that go into the manufacturing process all constitute important IP assets. Under this scenario, who owns the IP – the parent company or the manufacturing arm? Does the manufacturing unit owe the other unit a royalty for using the IP or do they own it jointly under a cost-sharing agreement? These are critical questions that must be adequately addressed.

Today, the ability to transfer and utilise IP instantly around the globe using the internet adds complexity to these issues. Because this high-speed, high-volume information flow exists in the digital cloud rather than in a distinct physical location, it invites questions about where the IP actually resides and whether or not it has actually traveled across a border.

Complying with the law starts with knowing the law, and the applicable laws are changing fast in many jurisdictions. To keep a company's profits in a tax favourable entity and jurisdiction and its IP creating value instead of costing the company money, its information systems must not treat IP as an afterthought.

Changes to the company's business model

Sometimes change comes as evolution: A computer hardware company might find itself emerging as a software leader or as a cloud service provider. Sometimes it's revolution: for example, health care reform in the US has many hospitals and insurance companies evaluating changing business models. Whatever the pace, a shift in business model changes everything, and if a business doesn't account properly for IP as part of that process, the potential tax implications can be detrimental.

Once again, the answer is to include IP tax planning from the outset. A multinational enterprise should conduct an IP assessment and take inventory of its IP portfolio and related business model. What are the IP assets, where are they located, how is the business utilising the IP assets, etcetera?

It will be important to weave a consistent plan regarding IP strategy that considers all the various constituencies and their interests. The legal and business teams will likely have IP strategies that are not necessarily focused on legal entity considerations. The tax professional must nonetheless be able to develop, determine, document, and support IP on a legal entity basis both from a proactive planning as well as a risk management perspective.

If a company's go-forward business model involves mobile or virtual services, it might be unclear where the IP assets that support those services are located for tax purposes, or where the transaction driving the value actually took place. The physical location of servers and other elements of an IT infrastructure can be key considerations, but not the only factors; contracts and customer relationships also matter. In addition, shared services centers that support operations in multiple jurisdictions can make the picture even more complex.

The alignment of a company's operating model and its global tax planning enhances the opportunity for value creation, and each must adapt to satisfy the demands of the other. Business model optimisation (BMO) is the process of pursuing this balance and integrating the operating model with global

tax planning into the way a business operates. Tax planning that is not based on operations can dramatically increase a company's risk profile. As a result, a business model that does not take tax planning into account may end up surrendering some or all of the profit it creates to higher taxes.

The four Rs

As businesses, tax laws and taxing authorities all change in sophistication, effective management of IP and tax planning become ever more important to multinational taxpayers. As with any IP tax planning, the four Rs should be considered.

Realigning for business transformation

Aligning IP tax planning and business strategies may or may not be part of a larger business model transformation, but every organisation should make sure its business model is capable of efficiently developing and deploying IP in the right way. This is the groundwork for everything that follows, so it is critical that management, operations, and tax professionals (whether internal, external, or both) partner in this assessment and design process.

Reconfiguring IT systems

IT systems must be able to support governance structures, supply chains, and every other part of a business in harmony. IP is an essential element of the overall framework and building this capability will touch upon access to financial data, tax policies, transfer pricing, approval processes, and other issues.

Readying human resources

Aligning strategies means changing functions, locations, and risks. That can mean moving people, which has the potential to trigger attrition, disruption, and leadership confusion. The potential talent implications of effectively implementing an IP strategy should not be ignored.

Reorganising for legal, finance, and tax structures

Changing the way valued assets move within and through a company can lead to unforeseen changes in customs, taxes (both direct and indirect), and calculations about ownership and profit. Organisations can't leave these elements to chance. Additionally, as calls for reform of the tax laws that affect IP tax planning continue, it is critical that tax planning be undertaken that fully integrates the importance of business operational substance as well as maintenance of appropriate documentation.

Maintaining shareholder value

As businesses seek new ways to drive revenue and profits while effectively managing cash flow and costs, effective IP tax planning is a critical component in creating and maintaining shareholder value. It can help companies create substantial value, protect their products and offerings, and provide a competitive advantage, all while helping them address and manage tax-related risks.

However, companies cannot consider IP strategy, tax planning, tax reform, and business strategy as separate items. These components all work together, and the way an organisation assembles its internal structure can have far-reaching effects on the tax liabilities that developing, protecting and deploying intangible assets entail.

More than anything, it's vital to have the right support. A sustainable, profitable, coherent approach to IP tax planning is too complex for almost anyone to tackle alone.

The venture valuation model and cost sharing CWI rules

Marco Fiaccadori, Arin Mitra, and Philippe Penelle provide a practical analysis of the venture valuation model and cost sharing rules.

The final cost sharing regulations published in 2011 introduced a new set of "commensurate with income (CWI)" rules, described in Treas. Reg. §1.482-7(i)(6) Periodic Adjustments.

In a cost sharing arrangement (CSA), if participant A makes a platform contribution (X) to the CSA, other participants are required to make a platform contribution transaction (PCT) payment to A for X. If the actually experienced return ratio (AERR) for those PCT payments is outside the periodic return ratio range (PRRR), which is 0.667 to 1.5 for those taxpayers who have "substantially complied" with the Treas. Reg. §1.482-7(k) administrative requirements (and 0.8 to 1.25 for those who have not), then the commissioner of Internal Revenue may make a periodic adjustment to other cost sharing participants' PCT payments to A.

The final cost sharing regulations include detailed guidance on the mechanics of how AERR and PRRR should be calculated, including the adjusted residual profit split method, but provide no substantive and direct linkages to reconcile the CWI rules with the arm's-length standard regarding the choice of approach and parameters. This article provides a general conceptual framework to discuss how different valuation methods relate to CWI rules, and demonstrates that a variant of a specific valuation approach, known as the venture valuation model, can resolve some of the challenges that arise in the context of applying CWI rules.

Valuation approaches

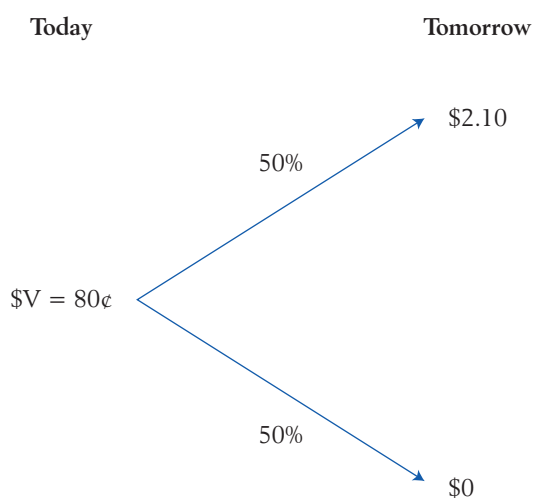
There are three key valuation approaches available to analysts and tax practitioners: the certainty equivalent (CE) approach, the cost of capital (CC) approach, and the venture capital (VC) approach. In addressing the central question of determining the value of an investment, these valuation approaches differ in how they treat (and measure) time value of money and risk, when risk can be further split into project risk and market risk.

Time value of money reflects the opportunity cost of time, and compensates the investor for trading off today's, versus tomorrow's, access to the invested capital. Time value of money is often represented by the risk-free rate r_f, which converts tomorrow's unit of value into today's unit of value, at no risk.

In addition to intertemporal tradeoffs, investment opportunities are subject to risks. In that context, risk is broadly defined as the possibility of different (future) realisations and circumstances that determine variability in the future value of the investment and ultimately affect its current value. Some risk, often referred to as project risk or diversifiable risk, can be fully insured or hedged against; that is, combinations of alternative investments perfectly offset the changes in value in all future realisations of a given investment. Therefore, an investor is guaranteed a constant future value in all world jurisdictions by combining all such investments. Specific risk

is commonly identified by the distribution of possible realisations and their associated probabilities of a single investment opportunity (for example, probabilities of success and failure of a project). Unlike idiosyncratic risk, the second type of risk relates to market or systematic risk, which is the risk that arises from the interaction of the investment with the market in aggregate, the result of which cannot be diversified away. Market risk is routinely identified by the amount of compensation the investor requires under market conditions for taking on additional risk over and above the risk-free rate, termed risk premium.

To keep things simple and illustrate how the CE, CC, and VC approaches deal with time and risk, we consider a stylised investment opportunity that has equal chances to cash out \$2.10 or \$0 tomorrow to the investor and is currently traded at price (or value) \$V = 80¢. The figure below provides a schematic of this investment opportunity (or PCT, when discussing this example in the context of a CSA).



All three valuation methods are forward-looking and assume the same amount of information is available to the analyst and parties to the transaction, but they use different inputs in their reconciliation with the market, arm's-length price. Table 1 shows the breakdown of the inputs for each approach and the associated numerical example based on the investment schedule discussed above.

The CE approach reduces the valuation problem to convert the expected (probability-weighted) cash flows so that the investment is remapped into a risk-free stream of expected returns. In the formula, all risk adjustments are done and accounted for in the numerator (first by calculating the expected value of the investment and second by scaling down the expected value by a certainty equivalent factor) while time value of money is taken care of in the denominator. In the example, the expected (probability-weighted) cash flow of \$1.05 is scaled down by a factor of 0.8, which reflects the market-risk attitude of the investment and discounted by the risk-free rate of 5%.

The CC method, used by most companies and tax practitioners, calculates the value of an investment by discounting the expected cash flows by a discount rate adjusted for systematic risk. In the formula, only diversifiable risk is accounted for in the numerator, while time value of money and systematic risk are taken care of at the denominator by the discount rate incorporating the risk-free rate and the risk premium. In the example, the expected (probability-weighted) cash flow of \$1.05 is discounted by the (risk-adjusted) weighted average cost of capital (WACC) of 31.25%, which reflects a market risk premium for the investment of 26.25% = 31.25% - 5% over and above the risk-free rate of 5%.

The VC approach values the investment based on a value multiple that measures how many dollars an investor expects in return for every dollar invested in the project at the time of a successful exit, which in the VC context is typically considered to be an initial public offering (IPO) or equivalent payoff event. The target multiple in our example of 2.625 reflects the time and risk reward required to invest 80¢ in the project when the investor anticipates \$2.10 in a successful exit. Note that when the target multiple is converted into a discount rate in the example, the resulting VC discount rate of 162.5% incorporates the time value of money and the total risk adjustment for this investment, where total risk includes both systematic and idiosyncratic risk. Arguably, the total risk premium of 157.5% = 162.5% - 5% arising from the VC approach is comprised of a market risk premium of 26.5%, as in the CC approach, and a project risk premium of 136.25%.

The VC approach

The key advantage of the VC approach is that it disassembles the valuation problem into two simple inputs: the expected value of the investment at the time of a successful exit and the target multiple of money on the investment.

While it is beyond the scope of this article to fully elaborate the VC approach, suffice it to note that a wide range of techniques is employed for the estimation of exit values and target multiples. Broadly speaking, exit valuations are estimates of the investment at some time in the future and contingent upon a specific event (a successful exit). Therefore, a reliable application of the VC method depends on the definition and measurement of successful exit and should be the subject of careful analysis by any analysts adopting this methodology. As a practical matter, a central idea of the VC approach is to ignore (or make first approximations of) lesser payoffs and focus on contingencies when the payoffs are significant or relevant to the investor. Therefore, in a VC method valuation target returns are measured against successful investments and only the successful cases are considered,

Table 1

Approach	Formula	Valuation elements	Denominator adjustment
Certainty Equivalent (CE)	$\$V = \frac{\$CE}{1 + r_f}$ $80¢ = \frac{0.8 \times (50\% \times \$2.10 + 50\% \times \$0)}{1 + 5\%}$	$\$CE$ certainty equivalent of investment r_f risk-free rate	Time
Cost of Capital (CC)	$\$V = \frac{\$EV}{1 + WACC}$ $80¢ = \frac{50\% \times \$2.10 + 50\% \times \$0}{1 + 31.25\%}$	$\$EV$ expected value $WACC$ is the weight average cost of capital of the investment	Time and systematic risk
Venture Capital (VC)	$\$V = \frac{\$Success}{M}$ $80¢ = \frac{\$2.10}{2.625}$	$\$Success$ represents the expected value of the investment at the time of a successful exit M is target multiple of money on the investment	Time and risk

with unsuccessful failure cases given an effective value of $0. Because of this representation, target multiples are the combined leverage of three elements: the probability of successful exit, p, the expected time of successful exit (with no further rounds of investment), T, and the weighted average cost of capital of the investment, $WACC$, as illustrated by the following simple formula:

$$M = \frac{(1 + WACC)^T}{p}$$

with the resulting discount rate, R_{VC}, implied by the valuation multiple from the VC approach:

$$1 + R_{VC} = M^{\frac{1}{T}} = \frac{1 + WACC}{p^{\frac{1}{T}}}$$

Note that in the example the time horizon simplifies to $T = 1$. This formula clearly shows how the VC approach incorporates all elements of time and risk when valuing investment opportunities contingent on success. It also shows that $R_{VC} > WACC$ whenever the probability of success is not 1. Put differently, to the extent there is project risk, the VC discount rate must be higher than the WACC.

Arm's-length standard and CWI rules

The connection of returns, expected returns, and net present value (NPV) of expected returns with the three valuation methods discussed above in the context of applying the arm's-length standard and CWI rules, in their specification under Treas. Reg. §1.482-7(i)(6) Periodic Adjustments, is crucial to the transfer pricing practitioner. In a nutshell, two moments in the valuation and CWI testing process can be distinguished in the context of a CSA:

A) Before and after the PCT, when each party holds different expected returns but the transaction leaves each cost sharing participant no worse off, with no lower NPV of expected returns.

B) Before and after the uncertainty/risk realisation when cost sharing participants (after the PCT) may experience actual, realised returns different from expected returns.

As stated in Treas. Reg. §1.482-1(b)(1) "[a] controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realised if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's-length result). However, because identical transactions can rarely be located, whether a transaction produces an arm's-length result, generally, will be determined by reference to the results of comparable transactions under comparable circumstances." In short, the arm's-length standard relates to point A above. In the example, 80¢ is an arm's-length price for the investment opportunity, and all three valuation approaches discussed above provide a coherent and internally consistent framework to support this conclusion.

Under Treas. Reg. §1.482-7(i)(6), the periodic adjustment rules refer to actual, realised returns, and therefore are linked to point B above. What would happen if we were to test the AERR when the investment is successful in our simple example? The (simplified) AERR test would check

the following ratio, where "ADR" stands for the applicable discount rate:

$$AERR = \frac{\frac{\$2.10}{1+ADR}}{80¢} = \frac{2.625}{1+ADR}$$

Based on the discussion presented above, it should now be apparent that to provide a correct NPV calculation, (1 + ADR) must be equal to the VC multiple M, resulting in an AERR of 1, as expected given that the PCT price is at arm's-length by construction.

It should be noted that while references to discount rates other than the one implied by the VC approach are present in the final CS regulations, (PCT Payor WACC) in discussing the ADR Treas. Reg. §1.482-7(i)(6)(iv)(B) allows for great flexibility in the choice of input based on facts and circumstances: "However, if the Commissioner determines, or the controlled participants establish to the satisfaction of the Commissioner, that a discount rate other than the PCT Payor WACC better reflects the degree of risk of the CSA Activity as of such date, the ADR is such other discount rate." See also Treas. Reg. §1.482-7(i)(6)(i). Applying different discount rates to the AERR calculation would lead to a mispricing of the realised investment and therefore incorrectly compare the value of the realised investment and the value of the PCT. Specifically, because investments (and PCT in the context of CSAs) generally carry significant project risk, using estimates of the risk-free rate (as in the CE approach) or the WACC rate (as in the CC approach) would systematically overvalue the realised investment and overestimate the AERR (in the example, respectively resulting in AERRs of 2.5 and 2, well above the PRRR) and more likely to trigger the PCT periodic adjustment. Note that additional considerations relating to exceptions to the periodic adjustments rule may be applicable, depending on the facts and circumstances of the PCT under analysis. See Treas. Reg. §1.482-7(i)(6)(vi) and Joseph Tobin, "2011 Cost Sharing Regulations: Probability Weighted Projections and Periodic Adjustments," mimeo (November 2013), for further discussion on the applicability of the periodic adjustments mechanism.

Conclusion

In the normal course of business, the existence of realised returns in excess of (or below) expected returns provide tradeoffs and incentives for investors to operate in active markets by exchanging and allocating risk in arm's-length transactions. To support the process of valuing such transactions, analysts have developed numerous techniques that identify and measure the key price determinants, such as time value of money and different forms of risk. Since the introduction of the final cost sharing regulations, some tax practitioners and commentators have raised concerns that the CWI rules under Treas. Reg. §1.482-7(i)(6) could be in potential conflict with the arm's-length standard and inconsistent with any sound models.

In this article we briefly outlined the three main NPV-based valuation methods available to tax practitioners and valuation analysts, and provided a general conceptual framework to illustrate how to reconcile the periodic adjustments rules with sound valuation principles and the arm's length standard by applying a variant of a specific valuation approach, known as the venture valuation model.

Biography

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Marco Fiaccadori is a senior manager in Deloitte Tax's Washington National Tax office. He has been part of Deloitte's global transfer pricing and international tax group since 2008. Mr Fiaccadori has extensive experience in company financial and quantitative research analysis and industry data. He has prepared economic analyses of intercompany pricing strategies, and assisted with transfer pricing planning, documentation, and competent authority negotiations for multinational companies in a wide range of industries.

Mr Fiaccadori has managed and coordinated transfer pricing projects involving business restructuring and intellectual property portfolios for global clients in the media and technology, pharmaceutical and medical equipment, lodging and hotel, automotive, and branded consumer products industries. He is responsible for the economic analysis and the day-to-day management of advance pricing agreements and cost sharing arrangement for global clients with local operations in the Americas, EMEA, and APAC regions.

Mr Fiaccadori earned his PhD at the Department of Economics of the University of Chicago, where he was also a lecturer in economics at the College before joining Deloitte.

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Arin Mitra is a principal and senior economist based in Washington, DC. He co-leads Deloitte's business model optimisation (BMO) practice and leads the Washington office's transfer pricing team. Over the last 18 years he has practiced in Deloitte's offices in Los Angeles, Tokyo, and Sydney.

Mr Mitra primarily focuses on complex BMO engagements related to the restructuring of intercompany transactions involving intellectual property, management and functional rationalisations, and supply chain rationalisations. He specialises in dealing with tax authorities on transfer pricing, including audits, competent authority negotiations, and advance pricing agreements (APAs). He has developed and negotiated transfer pricing methods for over 30 APAs, mostly bilateral, involving Australia, Canada, China, Japan, and the US. He has been recognised by *Euromoney* and the *International Tax Review* as a leading transfer pricing adviser in the US.

Mr Mitra has advised companies across a wide spectrum of industries, including media, telecommunications and technology; pharmaceuticals and medical equipment; and branded consumer products in planning and documenting their transfer prices. He has successfully defended several clients in audits conducted by the tax authorities and has worked with attorneys from several leading law firms.

Mr Mitra has published extensively on transfer pricing topics. He is a member of the American Finance Association.

Educational qualifications and professional affiliations

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Philippe Penelle, PhD, is a principal with Deloitte Tax, specialising in business model optimisation (BMO) strategies and transfer pricing solutions for some of the firm's largest multinational companies. He joined Deloitte in 1998 in the Chicago office and transferred to the Los Angeles office in 2010.

As the West Region Leader of Deloitte's intellectual property group, Mr Penelle leads a group of dedicated international tax and transfer pricing specialists in designing and implementing complex strategies to assist multinational companies structure their value chain functions (not limited to supply chain) and intellectual property holdings in a tax- and treasury-efficient manner.

With more than 14 years of experience in the valuation of intellectual property for transfer pricing purposes, Mr Penelle has not only assisted his clients in developing and implementing efficient tax structures, he has also represented them before the Internal Revenue Service in advance pricing agreement proceedings and in audit defenses. He has extensive experience in the pharmaceutical, oil & gas, consumer products, and apparel industries.

Mr Penelle is a regular external speaker, including at Council for International Tax Education (CITE) conferences, and the recipient of numerous presenter awards, including CITE's "Outstanding Star Speaker Award" in 2005, 2006, 2007, 2008, 2009, and 2011. He has published a number of technical articles on transfer pricing, as well as contributed a chapter to the Transfer Pricing Handbook published by John Wiley & Sons. Mr Penelle's most recent work includes three original technical articles commenting on the recently published US final cost sharing regulations. Two of these articles have been published in Bloomberg/BNA's *Transfer Pricing Report*; the third is under review and is forthcoming.

Mr Penelle was a lecturer in Economics at the College (1994-1996) and then Assistant Professor of Economics (1996-1998) at the University of Chicago before joining Deloitte in 1998. He has received a number of academic awards, including the title of Aspirant of the Belgian National Sciences Foundation (NSF) and Fellow of the Belgian American Educational Foundation (BAEF).

Mr Penelle earned his PhD in Economics from the Department of Economics at the University of Chicago in 1996, after earning a Master in Econometrics *suma cum laude* and a License en Sciences Economiques *suma cum* laude, both from the Université Libre de Bruxelles (Belgium).

Location-specific advantages: India and China

The issue of location-specific advantages (LSAs) has received significant attention recently, with India and China formally stating their positions in the UN Transfer Pricing Manual issued October 2012, and in subsequent discussions. Shanto Ghosh, Wei Shu, and Rahul Tomar explore the concept.

Multinational corporations (MNCs) have been relocating portions of their global supply chain to developing countries, including India and China, to generate efficiencies and remain competitive in the marketplace. Moreover, the vast consumer base in India and China, and the lowering of trade barriers have allowed MNCs to sell their products in these countries, sometimes at premium prices. As a result, the tax authorities in these countries have argued that their unique market features deserve separate recognition and compensation through appropriate transfer prices. The issue gets complicated because the option of relocating portions of a global supply chain in different countries is often available only to global MNCs and not to local, independent companies. Hence, there is a lack of available third-party data that may provide a basis for separately determining how LSAs are treated in arm's-length conditions. This issue is at the heart of the current debate on LSAs.

The BRICS block of countries has assumed significant relevance in the current global business environment because they house 40% of the global population, hold an estimated $4.4 trillion of foreign exchange reserves, and contribute 20% to global GDP. Transfer pricing developments in these economies have the potential to affect the operations and profitability of MNCs in significant ways. Hence, it is important to understand the LSA concepts being discussed and work toward consensus on how to identify, quantify, and allocate income arising from such LSAs.

LSAs are those location-specific market features and/or factors of production that enable a firm to achieve an improved financial outcome from the provision of the same product or service compared to alternative locations. They may include access to skilled labour, incentives, market premiums, access to growing markets, superior infrastructure, and cost savings.

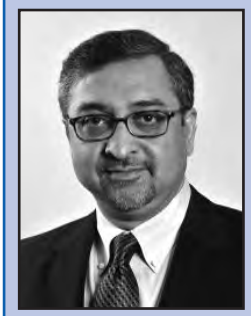
OECD, UN, and US views of LSAs

The OECD first acknowledged and addressed the issue of location savings in the new Chapter IX on transfer pricing issues associated with business restructurings that was incorporated into the OECD's transfer pricing guidelines in 2010 by stating:

> "The [allocation of significant location savings] that would be agreed between independent parties would normally depend on the functions, assets and risks of each party and on their respective bargaining powers." [Chapter IX, Business Restructurings, paragraph 9.149]

In the same section, the OECD transfer pricing guidelines provide examples that essentially argue that of the two entities engaged in trade, the entity that has the bargaining power, which in itself is driven by ownership of intangibles, will be able to claim the location savings. Subsequently, the OECD added a new section in its July 2013 draft of the chapter on intangibles dealing with the transfer pricing treatment

Biography



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Mr Ghosh is a transfer pricing partner in Deloitte India. He has recently relocated to the US and is located in Boston. Shanto has more than 13 years of transfer pricing experience, six of those years working in the US.

Mr Ghosh has advised clients in the life sciences, technology (including media and telecoms), and automobile sectors. He has been actively involved in assisting clients with their global transfer pricing policy and documentation, and has implemented a number of large-scale global planning and supply chain restructuring projects. He also established and successfully set up Deloitte's Global Transfer Pricing Center in India, which supports the global Deloitte network in performing global documentation studies for multinational companies.

Mr Ghosh has been recognised in Euromoney Legal Media Group's *World's Leading Transfer Pricing Advisers*. He has also been a a visiting lecturer at the IBFD and a member of *International Taxation* magazine's editorial board. He is a frequent speaker at international conferences across the globe and has published a number of high-profile articles.

In addition to his consulting experience, Mr Ghosh has been a teaching fellow at the Harvard Institute of International Development and a lecturer of Financial and Development Economics at the University of California, Berkeley.

Education
Boston University: PhD (Economics)
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of local market features, location savings, assembled workforce, and group synergies. The OECD has proposed a position acknowledging the presence of LSAs in MNC operations, but has emphasised that quantifying and allocating such benefits must be done in accordance with the arm's-length principle. It goes on to state that LSAs are comparability factors that should be considered in transfer pricing analyses, but are not in themselves intangible assets (but can involve intangible assets in certain situations). Moreover, sharing LSAs between group companies is best done through a comparability analysis, if the savings are not passed on to third-party customers.

The tax authorities of India and China formally laid out their position on LSAs in a separate chapter of the UN Transfer Pricing Manual that was released October 2012, departing from the quasi-consensus position on this issue the UN presented in the other chapters in the manual. India's and China's positions are discussed later in this article, but the UN's view is that LSAs may play an important role in increasing an MNC's profitability, and concludes that the allocation of benefits to the respective entities will depend on competitive factors relating to the nature of access to the LSAs and on the alternatives available to the parties given their relative bargaining power.

The US recognises the concept of location savings (as opposed to other types of LSAs) in Treas. Reg. §1.482-1(d)(4)(ii) of the transfer pricing regulations, which states that if the comparable company operates in a different geography, adjustments may be required for differences in the cost of resources, while considering the competitive position of the buyer and seller.

In summary, the OECD, the UN, and the US all recognise LSAs (or location savings) as an important factor in transfer pricing analysis, but reiterate their reliance on the arm's-length standard explicitly, stating that such factors are not separately compensable but should be dealt with as a part of the comparability analysis.

Economics of LSAs

The starting point of any transfer pricing analysis involving LSAs should be their identification. The perception that LSAs are available to an MNC can often be unfounded, particularly because an MNC's decision to locate its manufacturing or service operations in India and/or China may be driven more by competitive pressure from the markets that require them to lower costs simply to remain in business than by the prospect of benefiting from LSAs. Clearly, in such instances, location savings are passed on to the companies' end customers, and do not warrant any further changes to the prevailing transfer pricing arrangements. It is only in certain instances that LSAs give rise to location rents that are actually retained within an MNC.

Assuming that LSAs give rise to location rents, the process of quantifying the rent should take into account the net benefit to the MNC by recognising benefits and dissavings that can be inherent to operations in a developing country. Benefits may manifest themselves through low input costs, specialised skilled manpower, government subsidies, scale economies, and lower environmental standards. On the end-product market side, benefits may take the form of higher demand for branded products resulting in price premiums, entry barriers limiting competition, or unique features of the

consumers in a market that make it easier for companies to sell products into those markets.

These benefits may be offset by economic costs such as higher transportation costs, higher warranty costs, higher cost of capital, economic costs of managing an operation in a remote location, and higher indirect costs of doing business. The quantification of location rents should be based on a careful consideration of both advantages and disadvantages of operating in these markets. Incidentally, both India and China have acknowledged the presence of dissavings when quantifying LSAs.

Once the location rent is quantified, the next step in the analysis is to allocate this rent to the parties involved in generating such rents. Relative bargaining power is recognised as the key factor for that allocation. In the absence of third-party comparables that provide guidance on how such bargaining powers are manifested in market transactions, concepts of bargaining theory in economics provide useful guidance to determine how third parties would split such profits.

Several important factors affect the outcome of a bargaining situation:

a) Time value of money: one party's bargaining power is greater the more patient it is, relative to the other negotiator. All other things remaining constant, if all the entities on the bargaining table value the cost of waiting in the same manner (that is, the present value of the future is discounted at the same rate for all parties), the outcome will likely be one where each entity will split the location rent equally.
b) Risk of breakdown: While bargaining, the parties may perceive that the negotiations might break down into disagreement because of some exogenous and uncontrollable factors. For example, while two firms bargain over how to divide the returns from a new technology, an outside firm may discover a superior technology that makes their technology obsolete. The exact partition of the net surplus between the entities will depend on their relative degrees of impatience (as described above) and on their relative degrees of aversion to risk.
c) Outside options: A key principle is that an entity's outside option will increase its bargaining power if and only if the outside option is sufficiently attractive; if it is not attractive enough, then it will have no effect on the bargaining outcome. This is the so-called outside option principle (OOPS).
d) Role of commitment: In many bargaining situations, the parties often take actions before and/or during the negotiation process that partially commit them to some strategically chosen bargaining positions (or "demands"). Those commitments are partial in that they are revocable, but revoking a partial commitment (backing down from one's demands) can be costly. The presence of such commitments (such as a long-term supply contract with another member of the MNC) can have an impact on how location rents are split.
e) Asymmetric information: There may be instances in which one entity has access to relevant information important to the business that the other does not; such informational asymmetries will also have an impact on the bargaining outcome.

For a helpful overview of some of these concepts, see "A Non-Technical Introduction to Bargaining Theory," by Abhinay Muthoo, WORLD ECONOMICS, Vol. 1, No. 2, April–June 2000.

Often, it is difficult to argue that the location savings should accrue to the MNC entity located in the low-cost country because the intangible-owning entrepreneur entity

Biography

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Wei Shu is the lead economist of Deloitte China's transfer pricing practice. With more than 15 years of professional transfer pricing experience, he had worked in Washington DC, Los Angeles, and the Silicon Valley for seven years before he joined the firm's Shanghai office in June 2002.

Shu has assisted numerous multinational companies in various industries in both the US and China with transfer pricing contemporaneous documentation, tax authority transfer pricing audits, advance pricing agreements, and both compliance- and efficiency-driven transfer pricing/tax planning. His clients include large banks and companies in high-tech, textile & clothing, automobile, electronics, chemicals, pharmaceuticals, luxury goods, business services, sports goods, food & beverages in addition to a number of very large contract manufacturers. He was the China team's chief economist on China's first bilateral advance pricing agreement.

As one of the leading and most experienced Chinese speaking transfer pricing economists in the world, Shu is a frequent speaker on the Chinese transfer pricing issues and has published many articles in the BNA Transfer Pricing Report and other transfer pricing/international tax journals.

Shu holds a B.A. in economics from Fudan University in China and a Ph.D. in economics (finance minor) from the University of Maryland at College Park.

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Experience

Rahul is currently a senior director of transfer pricing in Deloitte's Delhi office. He led the Philadelphia transfer pricing group of Deloitte US before moving to India in October 2012.

He has more than 11 years of experience in transfer pricing, mostly in the US, and for another four years he has been involved in valuation, pricing analysis, and negotiation work.

Rahul has managed and led transfer pricing engagements involving planning, documentation, and controversy work, across more than a dozen industries, including healthcare, industrial products, technology and telecom. His specialisation is in assisting clients with transfer pricing planning, often covering complex transfer pricing structures involving intellectual property analysis, restructuring, and entity conversions. Rahul has also led global documentation projects coordinating with Deloitte colleagues in over a dozen countries.

He has co-authored a number of transfer pricing related articles published in international trade journals such as the Transfer Pricing Report and the International Transfer Pricing Journal, and has spoken in a number of seminars and forums.

Education

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- Rahul is also a CFA charter holder.

often has more options than the entity located in the low-cost country, thus reducing its bargaining power to retain any location savings that might exist.

India's position on LSAs

Over the last few years, the Indian tax authorities have been stressing that a portion of any LSAs should accrue to the Indian entity and be subject to tax in India. However, they have yet to announce or apply a systematic approach for identifying and quantifying LSAs.

The Indian tax authorities' aggressive view on this topic is clear from their submission to the UN Transfer Pricing Manual. India's submission begins by asserting that India not only provides location savings but other LSAs such as access to highly specialised skilled manpower and knowledge; access and proximity to a growing local/regional market; a large customer base with increased spending capacity; a superior information network; a superior distribution network; incentives; and market premiums.

The Indian chapter of the manual goes on to state, without much basis: "The Indian transfer pricing administration believes it is possible to use the profit split method to determine arm's-length allocation of location savings and rents in cases where comparable uncontrolled transactions are not available." This is a fairly aggressive stance, without much regard to how such an approach may be applied. India's submission also states that transfer prices defended using local comparable companies do not capture the benefit of location savings. India's tax department has already lost on this last position in the Income Tax Appellate Tribunal, the first judicial level at which income tax cases are argued in India.

The desire to include location savings in Indian profits has been raised multiple times by Indian government representatives in seminars, forums, tax assessments, and APA discussions. However, the authors have not come across any instance where the Indian government has been successful in quantifying the location savings and arguing that they should accrue to the Indian entity.

China's position on LSAs

China's State Administration of Taxation (SAT) first officially expressed its views on location savings in Guo Shui Han [2009] No. 106, and on market premiums in Guo Shui Han [2010] No. 84. In the SAT's view, many foreign corporations should have higher profit margins due to location savings and/or market premiums because of the lower cost and higher selling prices found in China. In recent years, the SAT has paid special attention to the automotive, pharmaceutical, and luxury industries because of the importance of LSAs in those industries.

The SAT has recently used LSAs (and other arguments) in transfer pricing audits. For instance, a foreign company's Chinese subsidiary was determined to adjust its income tax for more than RMB100 million for 10 years. LSAs also have been used in self-adjustments, which are similar to transfer pricing audits although not legally official and conducted by state tax bureaus. The SAT has also used LSAs in bilateral APA cases, especially in negotiations with Japan's National Tax Authority.

Chinese courts have adjudicated very few transfer pricing cases, and none of them involve LSAs.

In the SAT's view, Chinese companies should get most, if not all, of LSAs. But up to this point, the SAT has not come up with an acceptable approach to allocate LSAs benefits.

Suggestions and anticipated future development

According to the OECD transfer pricing guidelines, location savings should be allocated based on relative bargaining powers, but the guidelines are vague on the allocation of benefits. Even though the OECD guidelines do not mention market premiums, it is an important issue – at least in China – and should be taken into account as well.

The important issue is how to estimate and allocate LSAs. The calculation of LSAs may not be too difficult, as long as all location dissavings and factors such as custom duties are taken into account. Also, indirect approaches, especially for location savings, must be used because of the difficulties in using direct approaches and the need to repeat the procedure every year. The difficulty, rather, is how to appropriately allocate relevant savings/premiums.

There are several approaches for allocating location savings. One of them is using domestic or regional comparable companies. But in some countries, such as China, there are few domestic public companies. Another potential issue is that in the tax authorities' view, selected comparable companies are not comparable enough based on functions, risks, and products. But one thing for sure is that location savings cannot be estimated based on cost savings only, because some savings are passed on to customers.

It is comparatively easier to estimate and allocate market premiums. As long as taxpayers take the difference in selling prices in China/India and developed countries, and other relevant factors (such as custom duties) into account, the market premium can be reasonably estimated. The difficulty here is still about comparable companies, especially in China, because there are very few publicly traded distributors. For manufacturing parts, for the same reason, would it be reasonable to allocate market premium based on two companies' relevant cost, say the Chinese/Indian entity's own manufacturing cost and the foreign entity's value of important parts? The result may not be absolutely accurate, but at least it's reasonable.

The key in the near future is to engage with the tax authorities to share with them these positions and come up with reasonable ways to estimate and allocate LSAs.

The evolving procurement model

Michael Gilson, John Wells, Andrew Feinberg, and Andrew Newman explain why harnessing a company's procurement function is important in tax planning.

Procurement organisations in the future will look different to how they look today. They will be dealing with new market and supplier challenges that will require additional skills, knowledge, and tools to drive ever-growing savings goals. These challenges will likely change how companies look at procurement as an organisational function and an overall company competence. Therefore, as the procurement function evolves to manage these challenges and drive increasing value to the organisation, tax departments must focus on harnessing this value within their global tax planning.

The financial acumen and business linkages required of a procurement organisation are shifting dramatically. Over the past decade, procurement's purview has evolved from requiring core competencies in strategic sourcing and commodity management to demanding advanced capabilities in risk management, global supply, business outsourcing, and regulatory and tax issues. While procurement organisations have been successful in recent years gaining a seat at the table of their internal business stakeholders, there is always more that can be done to link up with the finance function to bring to bear more innovative operating model, tax, and foreign exchange solutions. The ability of procurement to squeeze the same year-over-year cost savings out of the same categories and suppliers has diminished, and a more creative and comprehensive approach must be considered to engage financial and tax expertise to continue to drive benefits.

Many of today's procurement fundamentals will stand in the years to come: category sourcing, baseline procurement systems, purchasing performance, and knowledge management. But the purchasing organisation of the future will need more. An important part of this will be the necessary collaboration between the tax and procurement functions in defining the value procurement adds to the overall organisation. Once this value is defined, the tax function will then be tasked with defining how to embed this value in its overall global tax planning.

This article explores both the opportunities and the process for procurement functions, tax departments, and key stakeholders in an organisation (finance, human resources, information technology, legal) to collaborate more closely to capture the full value created from the evolution of the procurement function.

Evolving procurement requirements and capabilities

Procurement in the future will encounter expanding risks and extended supply chains. The location of suppliers for both physical and virtual goods and services, as well as the geographic location of internal procurement staff and facilities may have growing and significant total cost and risk implications. Today, when it comes to managing supply chains on a localised basis, such activity is pressuring organisations, even those that are less resource-constrained than most. Tomorrow may bring the need to

do this in real time to predict and forecast outcomes, factoring in a range of cost, compliance, transfer price, credit (tax), and related inputs.

Centralisation versus localisation

Procurement will likely need a new operating approach to enhance localisation (regional enablement) and global support. Decisions regarding centralisation and execution may vary between organisations, but the need to define functional and organisational structure will always remain a part of overall processes, category sourcing, leadership, and execution roles – just as it is today. A good procurement structure not only enables procurement to support internal customers (and their needs) at more defined and localised levels, but also enables insight and action to adjust for balance of trade questions that might arise with customers.

It is imperative that discussions about centralisation versus localisation also include tax, trade, and finance, so key roles and risks are not located in jurisdictions that may give rise to adverse tax implications. Tax, trade, and finance should be included in these discussions at the earliest possible stage so the procurement function and important stakeholders within the organisation understand the opportunities to embed tax efficiency into their operating model.

For example, on a localised basis, a procurement organization might opt to support global marketing with a shared, data-driven infrastructure that supports a macro view of activities all the way down to hyper-local planning. Such a structure would enable a global marketing organisation (potentially centralised in a tax-efficient location) to manage agencies of record (and local teams and local agencies supporting execution) while providing for collaboration on improving measured outcomes across all media planning. But the same company might take a hybrid approach for direct materials categories, such as metal stampings, by centralising vendor management data collection in in a tax-efficient location that supports in-country procurement teams (including supplier quality and development resources). This example illustrates how companies look at categories (marketing and metal stampings) differently, and how tax must do the same. The business requirements will always come first in terms of how best to support the various categories and where activities must take place to drive specific efficiencies. Tax then can put forward its requirements in terms of where certain functions, risks, and assets can be more efficiently located from a global tax planning perspective. The ability of an organisation to match these requirements will determine how effectively it can embed tax planning within its operating model.

Business, systems, talent, and tax requirements should all be considered as future operating models are thought through. The risk of not having the full organisation, including tax, involved in the design of a new model is that key value drivers may not be built in at the appropriate time, and it may be too expensive or disruptive to build them in at a later date. This is especially true when the requirements involve the location of key people, altering legal ownership of property flows with respect to transactions, or changes to the systems. It is also expected, when an organisation successfully embeds all these requirements, including tax, in the design of its future procurement operating model that the procurement function will be involved in the eventual defense of the model before the tax authorities. This may be necessary if tax authorities assume that any changes to the model were made purely for tax purposes. It will be up to the procurement business leaders to explain to the tax authorities why they chose to operate in a way that allowed them to increase business efficiencies at the same time they were embedding tax planning into their model.

Linking procurement and finance

To achieve these goals, procurement will need to work with finance more closely to truly become responsible for not just how spend is managed, but how it impacts and meets the needs of the business. As with traditional transformation efforts, leadership and stakeholder engagement will remain essential, but with a new aspect of tax/finance-centric collaboration. Such a transition will require a shift in mindset away from price (even on a total costs basis) to also consider consumption, delivery, quantity, and foreign exchange and tax-related impacts.

Where does tax fit in?

As procurement migrates to a new model that manages increasing risk and drives greater value in the organisation, tax functions must earn their own seat at the table to help steer the future design so it fits within the company's global tax planning. To achieve this, tax must answer this question: how can the organisation align its evolving procurement model from a tax and finance perspective to capture the potential marginal improvements in a tax-efficient manner?

Typically the design of the new procurement model focuses on leveraging global scale while harmonising and standardising processes to drive efficiencies and cost savings. These efficiencies are further enabled by systems technology and other business process intangibles to remove costly touches from the supply chain through automation. Being close to suppliers is a key element, but there is typically a core group within the procurement function that is tasked with managing the organisation's overall procurement risk while also driving toward savings targets. Many times the business will not focus on the location of this core group, missing a critical opportunity.

Considering the establishment of a procurement operating company business model

Imagine that, instead of critical procurement roles that are involved in setting strategy and managing risk being dispersed

on an ad-hoc basis throughout the globe, they are co-located in a procurement operating company (POC) located in a tax-efficient jurisdiction such as Ireland, the Netherlands, Switzerland, or Singapore, providing the following services to the organisation:

- Global, regional, and local procurement strategy;
- Category management;
- Managing global and regional supplier relationships;
- Consolidating buying data to identify savings opportunities;
- Developing negotiating strategies;
- Providing training to the organisation on purchase-to-pay processes; and
- Managing the overall spend of the entire organisation from a direct and indirect perspective.

While this group centrally drives the overall procurement strategy and manages key global suppliers, regional procurement centers of excellence located close to suppliers manage local relationships and are responsible for negotiation and conclusion of procurement contracts with local suppliers. This procurement "hub and spoke" model allows the procurement function to achieve operational efficiencies while also providing the tax and finance functions with the ability to potentially locate a portion of the marginal improvement from the evolving model in locations with either a low statutory tax rate or where the tax authorities negotiate tax rates based on the projected economic footprint of the new organisation.

From a business perspective, the benefits of having these roles co-located can include faster decision-making while also allowing for a single procurement operating model to be chosen that drives standardisation and harmonisation from a process and systems perspective. The standardisation and harmonisation of both processes and systems typically provide significant benefits to the business in terms of reducing touches and opportunity for human error while reducing complexity and making it easier to train new people on the model. Standardisation and harmonisation can also provide benefits when integrating a new acquisition, as the model for aligning the two procurement organisations has already been defined.

These transformations can be extremely expensive to undertake, especially when they involve moving highly compensated roles or modifications to existing systems so companies will pull together a business case comparing the potential group savings the procurement organisation will provide against the one-time costs (systems reconfiguration, people move costs, consultant and attorney fees, etcetera) and the ongoing run-rate (incremental cost or savings of having roles located in new jurisdictions, administrative costs, potential tax-audit defense costs, etcetera) to make a decision. The tax function should be involved in defining the value that can be attributed to the POC and its spokes so an after-tax savings/benefit number can be used in the business case.

Biography

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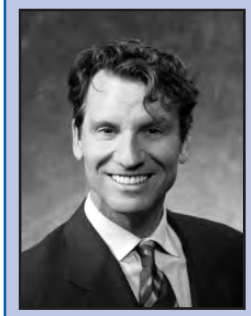
Over the last 17 years Michael has helped many clients in the manufacturing, consumer products, and services industries realign their value chain (marketing, sales, supply chain, procurement, manufacturing, quality) in both Europe and Asia by designing and implementing business model optimisation (BMO) methodologies involving the creation of tax efficient structures utilising principal or central entrepreneur companies located in Switzerland, Ireland, Singapore and other jurisdictions. These tax efficient structures typically involve the conversion of local sales companies into limited risk distributors and buy-sell manufacturing companies into toll or contract manufacturers operating under the direction of the European or Asian principal company.

Many of these projects involved analysing the tax efficiency of locations to hold the company's intellectual property (IP) and structuring the transfer of such IP.

It's important to note that there is no one-size-fits-all approach to defining the correct tax-aligned procurement model. While some organisations look at procurement globally, so that a "hub and spoke" model may make sense, other organisations may have a regional or commodity-driven model that allows for a simpler "singe central sourcing hub" approach. Additionally, some organisations may source most of their materials from a single country like China and therefore choose to use more targeted business and tax planning to capture the savings. In all these cases, procurement and key stakeholders must first drive how the business can most efficiently deliver value and grow over time. The role of tax is to share with the business the opportunities to align the model from a tax perspective (POC-type model, single central sourcing hub, country sourcing hub, etcetera) by explaining the tax requirements the business would need to live within so that both the tax and business benefits would be sustainable over the long term. The business – both procurement and key stakeholders – then decides whether it can live within the tax requirements. It is only when the business and tax are aligned that a truly sustainable tax-aligned procurement model can be implemented to drive sustainable tax and non-tax benefits.

Biography



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John Wells is the mid-America leader of Deloitte's US transfer pricing practice and the US energy sector leader. He is experienced in managing large projects involving quantitative analysis in the areas of transfer pricing and intangible valuation. Although his primary focus has been on the energy sector, Wells has provided services to clients across the industry spectrum, including Fortune 500 companies in chemicals, engineering, manufacturing, retail, software, and telecommunications.

Before joining Deloitte, Wells was the lead economist for the global energy and national resources sector of another big four firm, and an economic adviser to the Kuwait government. Wells was also a professor at Auburn University, where he taught PhD-level courses in time-series analysis, macroeconomics, and international finance. He has numerous publications and was a referee for the American Economic Review, Economic Inquiry, and other journals. Wells was awarded a National Science Foundation grant for his work on the effects of political events on financial markets.

Legal title flows

In addition to the location of key roles and the substance required in the POC, a critical part of the discussions between tax and procurement will include how best to manage legal title flows. Should the POC buy directly from the suppliers and then sell on to affiliates under a buy/sell model? Or should the affiliates purchase directly from the suppliers and pay a commission or service fee to the POC? From an economic perspective, the remuneration attributable to the POC may be similar under either approach as that value is driven by the functions, risks, and assets the POC manages. However, the title flows will affect the tax requirements analysis when it comes to managing permanent establishment concerns (who is binding whom) and indirect tax and customs issues.

Regardless of how the legal title flows operate, the POC will have to compensate the regional centres of excellence or spokes for their functions, risks, and assets. Typically, the regional spokes would be compensated on a cost-plus basis for the routine functions they are providing, while the POC captures the residual from managing the overall group risk.

As an alternative to the buy/sell or commission model, it is also possible to contemplate a hybrid buy/sell/service model whereby the POC and its spokes negotiate global pricing and rebates with suppliers. Under this model, the local affiliates purchase goods directly from the suppliers and retain the value of the group buying power through lower supplier prices. Under this option, the POC may be remunerated for its services by retaining a portion of the rebates it collects from the suppliers if the group achieves its volume goals.

Choosing the right tax-aligned procurement model

The chosen procurement model, whether it is buy/sell, commission, rebate, or another version, will depend primarily on the following considerations that should be defined during an initial opportunity/feasibility analysis phase involving key stakeholders to ensure the organisation does not move down an unsustainable path:

- Business transformation: How is the procurement function evolving and can it operate within the tax requirements? For any tax benefits to be sustainable, the business must be able to live with the model, so business sign-off before implementation is critical.
- ERP enablement: Can the systems technology support the model in a cost-efficient manner? Harmonising and standardising processes will reduce costs and enable the POC to effectively manage the procurement function globally.
- People impact: Can the appropriate people move to the POC and spoke locations, and is the cost of these moves manageable? Locating highly compensated employees in expensive locations such as Singapore or Switzerland can be a show stopper, so identify these costs up front.
- Tax risk management: Are the tax risks from migrating to and operating under the model manageable?
  - Base erosion and profit shifting (BEPS): With the current focus on BEPS by the G20, the OECD, and many governments, there is increased interest in the concept of companies paying their "fair share" of tax. The OECD BEPS action plan essentially requires that tax planning must be married with how the business chooses to operate, so that the substance of the business matches the location where the profits accrue. From an operational perspective, that means business must choose to operate in a manner, and from locations, that drive sustainable tax savings. In other words, locating the appropriate level of substance in the POC is a critical first step to managing ongoing tax risk.
  - Transfer pricing risk: Once tax and procurement have agreed on the right substance to be located in the POC and the appropriate level of remuneration, it is necessary to address remaining transfer pricing issues arising out of the model. Are the centers of excellence and local affiliates being properly remunerated? How should business process intangibles developed by the

POC be rewarded? Are the mark-ups, commissions, and/or contribution analyses supportable from a local country perspective? The transfer pricing studies prepared as part of these projects will form the basis of the company's defense in any future disputes with tax authorities, so it will be critical that they tell the story of the procurement function's evolution and explain the commercial rationale behind the transformation. The business also should review and sign off on these studies to confirm they properly reflect what's happening on the ground. This will prove invaluable when the tax authorities interview the business leaders, and their interviews are consistent with the company's transfer pricing studies.

- Exit charges: While undergoing the transformation, have any local affiliates transferred valuable intellectual property or other assets to the POC that require compensation? The intellectual property could be in the form of supplier databases, valuable "in-the-money" contracts, and other assets that allow the POC to drive future value for the organisation. Before transferring such items valuations should be prepared to substantiate the compensation due to the transferor. Alternatively, the transferor could license to the POC the right to use specific rights in their business. In the case of "in-the-money" contracts it may make more economic sense to let the "owner" of the contract earn out the value of the contract instead of transferring to the POC and incur a one-time tax charge.
- Permanent establishment (PE) concerns: Tax authorities may argue that the POC has a taxable presence or PE in their jurisdiction because of the activities of the POC or the local affiliate, if the local affiliate acts in the name of the POC on a regular basis. If a PE is created, the tax authorities will try to attribute profit to the PE, potentially negating the tax advantages of the chosen structure. In most cases, the POC will have a PE in a tax jurisdiction if the POC has a fixed place of business in that jurisdiction from which it carries on its business activities. A fixed place of business could include leasing or owning warehouses where goods are stored; thus, ownership of any property by the POC outside its country of incorporation should be avoided. Additionally, to avoid the creation of a "dependent agency" PE, it will be necessary to determine that no employees of a local affiliate sign contracts in the name of the POC or are deemed to bind the POC through their actions. This can be challenging when the POC operates on a buy/sell basis and employees of a regional center of excellence or local affiliate have responsibility for issuing binding purchase orders (POs) with suppliers. Because these POs will be issued under the name of the POC in a buy/sell model, tax authorities may argue that the local employee issuing the PO creates a PE for the POC. While some income tax treaties exempt preparatory and auxiliary activities, including "purchasing activities", from the definition of a PE, the question arises whether a "purchasing activity" could ever be considered "preparatory or auxiliary" for a POC whose sole purpose is to procure goods. Therefore, many companies that implement a POC buy/sell model choose to implement within their ERP system the ability for the POC to approve all supplier contracts and pricing terms so no PO can be sent to a supplier the POC has not already approved.
- Indirect taxes: Finally, indirect taxation issues such as VAT, GST, customs, and trade issues should be carefully analysed to identify any incremental costs that may arise from the POC stepping into the middle of the organisation's flows. Typically, these issues are manageable when operating in Europe, but significant hurdles can arise in certain countries in Asia as well as throughout Latin America.

How much value can we ascribe to the POC?

Many of the issues listed above will depend on the substance and value provided by the roles filled by the POC. From a transfer pricing perspective, it will be important to show that

Biography

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Andrew provides cost reduction and cash generation consulting services within Deloitte Consulting's Strategy and Operations practice, with a specific focus on supply chain management and sourcing & procurement.

Andrew has over 19 years of experience in consulting and operational roles. He has significant leadership experience in industry as the head of a procurement organisation, and as an operational and strategy consultant on client engagements.

Andrew specialises in working with global supply chain and procurement professionals to formulate strategy and organisational design, execute rapid diagnostics, and lead strategic sourcing, logistics, supply chain strategy and planning engagements.

Biography

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Andrew Newman is a tax partner specialising in international tax matters for multinational companies (MNCs). With more than 30 years of experience, he serves multinational clients in a variety of industries, including manufacturing, services, specialty chemicals, fast-moving consumer goods, food processing, and distribution and franchising.

Mr. Newman is the Co-Global Leader of the Business Model Optimisation (BMO) service offering. In this role, Mr. Newman is heavily involved in working with MNCs in optimising their supply chains and operating models and the tax benefits that can flow from such business transformations. This has included the design and implementation of principal and intellectual property company structures for Europe and Asia. BMO focuses on creating value though business transformation.

Mr. Newman has performed numerous global strategic tax reviews for MNCs to focus on reducing their worldwide effective tax rates. In addition, he has been instrumental in pioneering a new approach to managing the effective tax rate of a global company while optimising its utilisation and repatriation of offshore cash. He has successfully implemented this Global ST2EPS methodology for many U.S.-based multinational companies.

In a highly regarded international survey on tax advisors, Mr. Newman recently was recognised as one of the leading international tax service professionals in the central region of the United States. The study, conducted by the *International Tax Review*, gathers and assesses feedback on accounting and law firm tax advisers from 2,000 in-house tax experts and chief financial officers at major companies and financial institutions throughout North America. Mr. Newman is also listed as one of the 2010 World's Leading Tax Advisor's.

Mr. Newman has published several articles on international tax matters in such magasines as *The Tax Executive*, *Investment USA*, and *The International Tax Management Journal*. Mr. Newman is a co-author of the *BNA Portfolio on the Allocation and Apportionment of Deductions*. He has spoken on international tax matters to various tax groups, including The Chicago Tax Club, the Tax Executives Institute, CITE, the International Fiscal Association, and the National Chamber Foundation.

Mr. Newman is a member of the International Fiscal Association, the American Institute of Certified Public Accountants, and the Illinois CPA Society.

the POC generates significant value to the group through its activities and risk management capabilities. The question that arises is how much can the POC keep of those savings and how much will it have to share with other members of the group. In many cases this will come down to an economic analysis defining the relative contribution analysis of the POC and the affiliates. While the factors used for the contribution analysis will differ based on the type of procurement activities being centralised (commodities, ingredients, packaging, component parts, finished goods from low-cost countries, etcetera) there are some significant activities that should be compared:

1) The importance of the value and volume of purchases as part of the procurement strategy, the benefits of which may arise passively due to the association with a controlled group vs. a specific POC contribution.
2) The pervasiveness of existing relationships with suppliers prior to POC implementation may also lean toward weighing this as a group vs. POC contribution, or as an intangible that should be acquired and managed by the POC.
3) The development of new global or regional relationships, or driving additional value from existing relationships may be a significant POC contribution.
4) Creating innovative procurement strategies should be a POC contribution.
5) Developing, implementing, and executing the procurement strategies for specific products, markets, and suppliers may generate cost savings that are left in the POC or shared with group members.
6) The ability to gather, access, and perform analytics on procurement data is typically a POC contribution.
7) The ability to represent global markets to propose and negotiate the strategy should lean toward the POC.
8) Developing a negotiating strategy and framework for new terms and conditions may be a shared contribution.
9) Negotiations with suppliers and concluding contracts will depend on who is tasked with these responsibilities and will need to factor in analysis regarding dependent agency permanent establishment concerns.
10) Ownership and control of existing IP and data processing systems, and how these will be employed and supported on a go-forward basis should be established if an organisation is migrating to a POC model.
11) The value of new IP and data processing systems should inure to the POC if it is responsible for developing and funding the new capabilities.
12) Managing regulatory issues is typically a POC activity, but may be shared with local affiliates responsible for day-to-day compliance.

Relevant factors, as mentioned above and the comparative weighting between the POC and the group will be determined by company-specific facts and circumstances. However, the factors listed provide an overview of the con-

siderations to be used when an organisation is defining its future procurement model to gauge the level of potential savings that may be earned by the POC. Obviously, the greater the contribution made by the POC the greater the value that can be attributed to its functions, risks, and assets. It is of course necessary to weigh the value of the factors in relation to one another to arrive at an overall contribution percentage between the POC and the group. The exercise is not finished until the level of savings is defined, which may vary over the life of the organisation. The OECD, in its Revised Discussion Draft on the Transfer Pricing Aspects of Intangibles issued July 2013, framed this particular issue as follows:

> If important group synergies exist and can be attributed to deliberate concerted group actions, the benefits of such synergies should generally be shared by members of the group in proportion to their contribution to the creation of the synergy. For example, where members of the group take deliberate concerted actions to consolidate purchasing activities to take advantage of economies of scale resulting from high volume purchasing, the benefits of those large scale purchasing synergies, after an appropriate reward to the party coordinating the purchasing activities, should typically be shared by the members of the group in proportion to their purchase volumes

Similarly, U.S. Treas. Reg. Sec. 1.482-9(l)(3)(v) maintains that, "A controlled taxpayer generally will not be considered to obtain a benefit where that benefit results from the controlled taxpayer's status as a member of a controlled group".

US Treas. Reg. §1.482-9(l)(5) provides five examples that illustrate the implications of this concept. Importantly, from both an OECD and US transfer pricing perspective, simple aggregation of purchases that lead to volume discounts is not an activity that entitles the POC to claim a significant portion of these discounts. Such activities would provide the POC only with a routine return for its logistical functions.

For the POC to drive significant value and receive non-routine returns, it must be demonstrable that the POC develops, controls, and helps implement strategic sourcing solutions that lead to cost savings/profits beyond those that would be associated with higher volumes alone. The POC should have similar control over the business process intangibles, systems, platforms, and data analytics that underlie these strategies. Finally, it may be necessary to buy in to preexisting IP or long-term vendor relationships that are leveraged by the POC in its day-to-day activities.

Conclusion

The OECD's focus on the issues discussed above is recognition of the fact that the market demands that multinationals increase the value arising from their procurement function in a tax-efficient manner. It is up to tax departments to sit down with their supply chain and procurement leadership to make sure tax has a seat at the table as long-term procurement design decisions are made.

Indicia of economic ownership of intangible property

The question of who owns intangible property has been at the forefront of many transfer pricing controversies. Aydin Hayri and Darcy Alamuddin present a framework for identifying the economic or beneficial owner of intangible property, which from a transfer pricing perspective can be just as important as legal ownership, and illustrates its use in the case study of a hypothetical life sciences company.

This article sets forth five indicia of beneficial ownership that should be the starting point of any transfer pricing analysis regarding intangibles. The identification of the beneficial owners should be completed before the quantitative analysis of the transfer prices.

Framework

We limit our discussion to what we call "commercialisable intangible properties", (CIP), which we define as any intangible that fits the definition in US IRC §936(h)(3)(B) and that could potentially be transferred between unrelated parties. The §936 definition generally includes patents, inventions, formulae, processes, designs, patterns or know-how; copyrights and literary, musical, or artistic compositions; trademarks, trade names, or brand names; franchises, licenses, or contracts; and methods, programmes, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists or technical data. An intangible attribute that cannot be subject to transfer between unrelated parties on a stand-alone basis would not be property and therefore should not be included in the definition of CIP. For example, informal know-how – know-how in the form of collective or individual experience of employees – falls into this category. It is never sold as intellectual property, but may be utilised to provide services. Nonetheless, a transfer of a portfolio of properties, or a business, may still be split into separate categories for analytical purposes only. For example, purchase price allocations split the value of a business deal among different categories, but this does not mean that each category defined for analytical purposes would constitute CIP.

Some CIP, such as patents or trade secrets, may be legally registered or protected; in those cases, multinational groups often prefer to carry the legal registration in the name of a group member that gives them the greatest advantage in potential litigation, as acknowledged in paragraph 73 of the Revised Discussion Draft on Transfer Pricing of Intangibles issued July 30 2013. In many cases, group companies do not go through the effort of documenting the separation between legal and economic ownership through formal license agreements. Besides the divergence of legal and economic ownership, many CIPs may not be subject to legal protection (such as certain aspects of know-how, or customer relationships) and may not have legal owners. This raises the issue of beneficial ownership (also referred to as economic or tax ownership).

This article proposes that there are at least five significant indicia of beneficial ownership: cash, capitalisation, conduct, control-executive, and control-operational.

A presumptive beneficial owner would be expected to meet most, if not all, the indicia, as explained below:

1) *Cash.* Assume upfront responsibility for all of the CIP's necessary development or acquisition costs. Did the presumptive owner put capital at risk?

2) *Capital*. Arrange reasonably adequate capitalisation upfront to withstand the potential failure of the development effort (instead of relying on future capital injections). Would it make economic sense for a company with the presumptive owner's resources to have attempted such a development project?
3) *Conduct*. Secure proper legal rights to the CIP and memorialise the intended course of conduct. Following through with the implementation of such course of conduct is also important. While the ultimate legal registrations may not be in the name of the beneficial owner, there must be some type of documentation of the initial intent regarding which party would be the beneficial owner. Has the presumptive owner made arrangements upfront and conducted development and commercialisation efforts in a consistent manner?
4) *Control— Executive*. Exercise managerial control over the business activities that directly influence the amount of income or loss realised from the CIP or their development. Did the presumptive owner set the budget, and make the strategic decisions for development, protection, and value preservation? These questions are consistent with the guidance provided in paragraph 79 of the Revised Discussion Draft on the Transfer Pricing of Intangibles.
5) *Control – Operational*. Exercise operational control over CIP development or commercialisation. Did the presumptive owner design the development programme and make the most of the critical operational decisions? Please note that Treas. Reg. §1.482-1(f) appears to suggest either managerial or operational control: "Exercise managerial *or* operational control over the business activities that directly influence the amount of income or loss realised." Hence our separation of the two aspects of control.

Among the five indicia above, the last two – executive and operational control – appear to be the focus of recent governmental efforts. They are challenging concepts for transfer pricing because the arm's-length principle is applied under a presumption of independence of the parties. To apply the presumption of independence, we should first determine who is the owner of the property involved in the transaction, and then apply the relevant methods. Conducting a transfer pricing analysis and the determination of beneficial ownership at the same time may cause some confusion.

Case study

Our case study involves Pharm, an emerging biopharmaceutical company headquartered in Country H, with subsidiaries in three other jurisdictions:

- *R*, where it conducts research;
- *D*, where it does further development and eventual commercialisation; and
- *S*, where it has support personnel (scientists and commercial people) helping with development and commercialisation.

Biography

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Aydin Hayri is a principal in the Washington, DC office of Deloitte Tax. He is the life sciences industry leader for the transfer pricing practice, and manages our Philadelphia transfer pricing practice group. He has been with Deloitte since 1998.

Mr Hayri assists clients with transfer pricing planning involving global and domestic intellectual property development and licensing strategies; and planning and implementation of supply chain and business model restructurings. He has provided thought leadership by developing and applying China and the Far East sourcing strategies, such as adjustments for manufacturing and distribution risk differences, and adjustments for recession, market share, and book-to-market value differences. In addition to the pharmaceutical industry, his experience covers the medical device, defense/aerospace, manufacturing, and retail sectors.

Before joining Deloitte, Mr Hayri was an assistant professor of economics at Charles University, Prague; the University of Warwick, England; and a research fellow at Princeton University. His primary specialization was industrial organization, with emphasis on the economics of risk, uncertainty, and valuation. He taught courses on this subject, published articles in international journals, and obtained grants from the European Commission, the Economic and Social Research Council, and the World Bank. Mr Hayri still teaches occasional courses for MBA students.

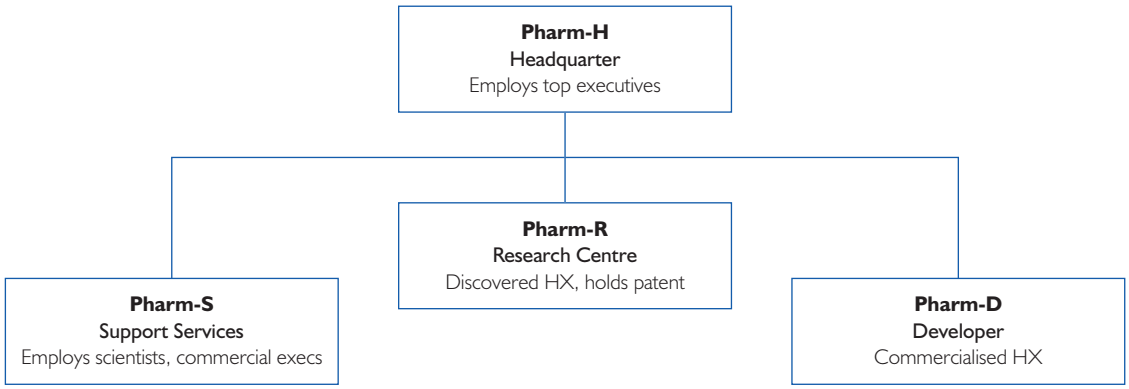
Education

PhD, Economics, Princeton University
MA, Economics, Princeton University
BA, Economics, Bogazici University, Istanbul

Selected transfer pricing publications

- "The Branded Prescription Drug Annual Fee and Transfer Pricing," 21 *Transfer Pricing Report* 339, July 2012.
- "Is it Time to Revisit Transfer Pricing? Economic Downturn and Transfer Pricing" with Kaoru Dahm, *Tax Notes International*, March 2010.
- "Neither a Distributor Nor a Commissionaire: Benchmark Returns for Low-Risk Distributors," with Michael Aarstol, *Transfer Pricing Report*, July 2003.
- "Firm Profitability in Recessions," with Dick Clark, *Transfer Pricing Report*, BNA, May 1, 2002 and March 6, 2002.

Diagram 1



Pharm's legal entity organisation chart is provided in Diagram 1.

Pharm-R had been responsible for the underlying research and discovery of HX, a new therapy for a genetic disease. By 2010, Pharm-R's patent application in all major jurisdictions was accepted, and all preclinical work on HX was completed. At that time, Pharm did not have any presence in *D* or *S*. Chief executives working for Pharm-H have had oversight over all strategic decisions, secured funding for the enterprise, and provided equity capital for Pharm-R.

The first question to ask is whether Pharm-R is the bona fide beneficiary owner of the HX patent.

While this seems straightforward, application of the five indicia reveals some ambiguity:

1) Cash: Pass. Clearly, Pharm-R funded all the research.
2) Capital: Pass. The flow of funding for Pharm on a consolidated basis had been through competitive markets. However, a question comes up whether Pharm-H injected all incoming capital directly into Pharm-R. What if Pharm-H funded Pharm-R on an as-needed basis? This would be a concern only if Pharm-R had received external financing (debt or supplier payables) that it could not have satisfied had the development of HX failed.
3) Conduct: Pass. Pharm-H executives' fundraising is a shareholder activity and Pharm-R would not normally pay a service fee for that. Assuming the oversight by chief executives was in the form of stewardship and duplicative review, no service fee would normally be required. Notwithstanding the typical facts described above, an additional cautionary step would have been to execute a services agreement between Pharm-H and Pharm-R, and have Pharm-R pay a service fee for any operational support Pharm-H executives may have provided.
4) Control-Executive: Ambiguous. As in any multinational enterprise, all decisions are subject to approval by the chief executives who receive recommendations and support from their subordinates. It would be unreasonable to expect Pharm-R to have taken actions against the policies and directives of Pharm-H. Recognising that the *raison d'être* of a multinational enterprise is to centralise such executive decision-making, what would be the level of executive control one would expect in a subsidiary? We believe a reasonably independent corporate governance mechanism for a subsidiary may suffice. This would normally be in the form a corporate board and, depending on the nature of operations, a full-time director. The terms of reference of the corporate governance mechanism would be to confirm that the decisions taken by headquarters are consistent with the corporate interests of the subsidiary. In our example, the board and/or the director of Pharm-R should have been able to assess whether the research project selection and funding decisions would have been significantly different for Pharm-R in the absence of Pharm-H's controlling ownership interest. This would be a reasonable test of this index of beneficial ownership, but the rules on this point are still evolving.
5) Control-Operational: Pass. Pharm-R personnel conducted the research leading to the discovery of HX.

As HX launched into clinical development, Pharm started operations in Country D and Country S, and hired personnel there who would manage some of the clinical studies that would be conducted around the globe. The actual clinical studies would be run by independent contract research organisations, CROs, and the clinical study protocols would be designed by Pharm-R personnel, with some input from Pharm-D and Pharm-S employees. More of the employees are with Pharm-S than Pharm-D. However, Pharm-D secured

an exclusive license for the HX patent from Pharm-R, assumed the funding responsibility for all clinical development, engaging Pharm-S and Pharm-R as contract research service providers. Pharm-D applied and secured all regulatory approvals and began selling HX around the world through related and/or unrelated distributors.

The second question to be posed is whether Pharm-D is the legal and beneficial owner of the right to sell HX on a global basis.

The answer is more complex than for the first question, with many ambiguities.

1) Cash: Pass. Clearly Pharm-D funded all the development, and pays the license fees to use Pharm-R's patent.
2) Capital: Pass. The same comments as in the first question apply.
3) Conduct: Pass. Pharm-D appears to have put in place all necessary agreements (patent license, service agreements, etcetera) in a timely manner.
4) Control-Executive: Ambiguous. Pharm-D's board reviewed all contracts with related and unrelated parties and approved their execution. The board also reviewed clinical development plans, which compounds to fund, which indications to pursue, how much to budget, and what endpoints to target during its periodic meetings, and issued guidance to Pharm-D officers about important matters to monitor when the board was out of session. However, these strategic decisions were all made by Pharm-H or Pharm-R personnel, with feedback from others as necessary. The critical test here is whether Pharm-D directors, or the board, have had opportunities to review these strategic decisions and their potential financial consequences from Pharm-D's perspective. If there is a corporate governance process that allows such a review and avoidance of excessive risk-taking by Pharm-D, this index of beneficial ownership would be satisfied. One important caveat should be kept in mind regarding the capabilities of the board and the directors of Pharm-D. It is expected that the board has the background and experience to be able to "make" the decisions they reviewed.
5) Control-Operational: Ambiguous. Unlike the analysis in the first question, Pharm-D's actual operational involvement in the development and commercialisation process, although significant, was not as substantial as Pharm-R's role in the research and discovery process. While Pharm-D personnel had some operational roles, it appears that most of the operational decisions, such as the design of clinical trial protocols, responses to adverse events, or the monitoring of the unrelated CROs were taken by others at Pharm-S or Pharm-R. Does this lack of operational involvement jeopardise Pharm-D's presumptive beneficial ownership? This issue may be approached on two levels: First, identify the types of operational decisions that can potentially be left to an outsourced service provider. Pharm-D's lack of

Biography

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Darcy Alamuddin is a principal in the Chicago office of Deloitte Tax's transfer pricing practice. With 18 years of experience, Darcy provides multinational clients with tax consulting services on many aspects of transfer pricing and international taxation. Darcy has worked on a wide variety of transfer pricing issues that include planning, strategy review, audit defense, and documentation engagements. In the context of these engagements, she works with clients in the areas of structuring, tax minimisation, and foreign tax credit planning. Her projects have covered headquarters services, inbound and outbound tangible product transactions, outbound migration of intangible product transactions, licensing of intangible assets, business model optimisation projects and the provision of contract R&D and trading services. Darcy has served French, German, Japanese, UK, and US multinational corporations.

Specifically in respect to headquarters services projects, Darcy has performed 15 to 20 of these headquarters studies for various clients. The results of these studies have supported service fees to be changed a quantifying the service fee amount as part of a bundled system royalty. Additionally Darcy has suggested these changes with great success in local country audits in the US, UK, Canada, Germany, etcetera, with the creation of local country reports.

Darcy has spoken at seminars on both international tax and transfer pricing. Her seminars on international tax have addressed topics such as global earnings mobilisation, the taxation of intellectual property, the allocation and apportionment of interest expense, and Subpart F. She has spoken on European, Japanese, South American and US transfer pricing issues in Japan and the US. Darcy's seminars have been sponsored by, among others, ATLAS Information (US), Interstate Tax Report (US), Global Education Services (US), Deloitte Touche Tohmatsu (US), and the Mitutoyo Corporation (Japan).

Last year Darcy was accepted into the IWF Leadership Foundation which selects exceptional emerging women leaders from the corporate, government, academia, and the non-profit sectors for its acclaimed Fellows Program, a year-long intensive training programme. Darcy was one of 35 rising women leaders from 14 nations selected, making it the largest and most competitive pool of candidates in Fellows Program history.

Darcy holds a BBA and JD-MBA from the University of Wisconsin-Madison.

involvement in such decisions would not normally jeopardise its beneficial ownership claim. Second, elevate the remaining decisions to the level of executive control and require a concurring review from the board or directors of Pharm-D. This would normally require an operational process to secure such a review on a timely basis.

Powerful tool

The framework presented in this article can be a powerful tool for reviewing the beneficial ownership of intangibles for transfer pricing purposes, before conducting an economic analysis of the pricing. The analysis of a relatively simple structure identifies challenging issues with respect to conflicts with the internal operations of a multinational enterprise when decisions are centralised to avoid duplication. While good practices at the subsidiary level corporate governance may address most issues, taxpayers may benefit from additional rulemaking to clarify the degree of due diligence and capability expected from a subsidiary's board and directors.

Transfer pricing of intangibles: Media and entertainment

The US television production industry, just one of the segments within the media and entertainment space, reported total revenue of $35.6 billion and a profit of $6.1 billion, or 17% of revenue in 2012. Mark Nehoray, Kristine Riisberg, and Anna Soubbotina take an industry focused look at dealing with intangibles.

Media company stock has appreciated about 43% over the last year, while one of the best performing stocks appreciated more than 58% since October 2007, according to Industry Group Tracker data published by The Wall Street Journal online on December 2013.

Driving the media industry's gains is a growing advertising revenue and the fact that digital distribution revenue is proving accretive, rather than, for example, cannibalising revenue from cable distribution. Companies in the media and entertainment space derive their revenues from a number of sources, such as selling advertising space, licensing original content, box office ticket sales, home video sales, on-line subscription revenues, pay-tv, video on demand, merchandising, amusement park admissions, and video game sales. All these sources at their core depend on one key ingredient – the companies' ability to attract viewers by creating valuable proprietary content and building popular brands.

Because the profits of diverse revenue streams are often recorded within disparate departments over the course of a long lifecycle, it is often difficult to accurately capture the full returns from proprietary content. While there are many other forms of intangible property that contribute to the success of the media and entertainment businesses, we will focus on intangible property that is most specific to the media and entertainment industry; that relate to content creation and monetisation. We will then discuss how these intangibles fit into the intercompany value chain and which factors to consider when determining appropriate compensation for these intangibles from a transfer pricing perspective.

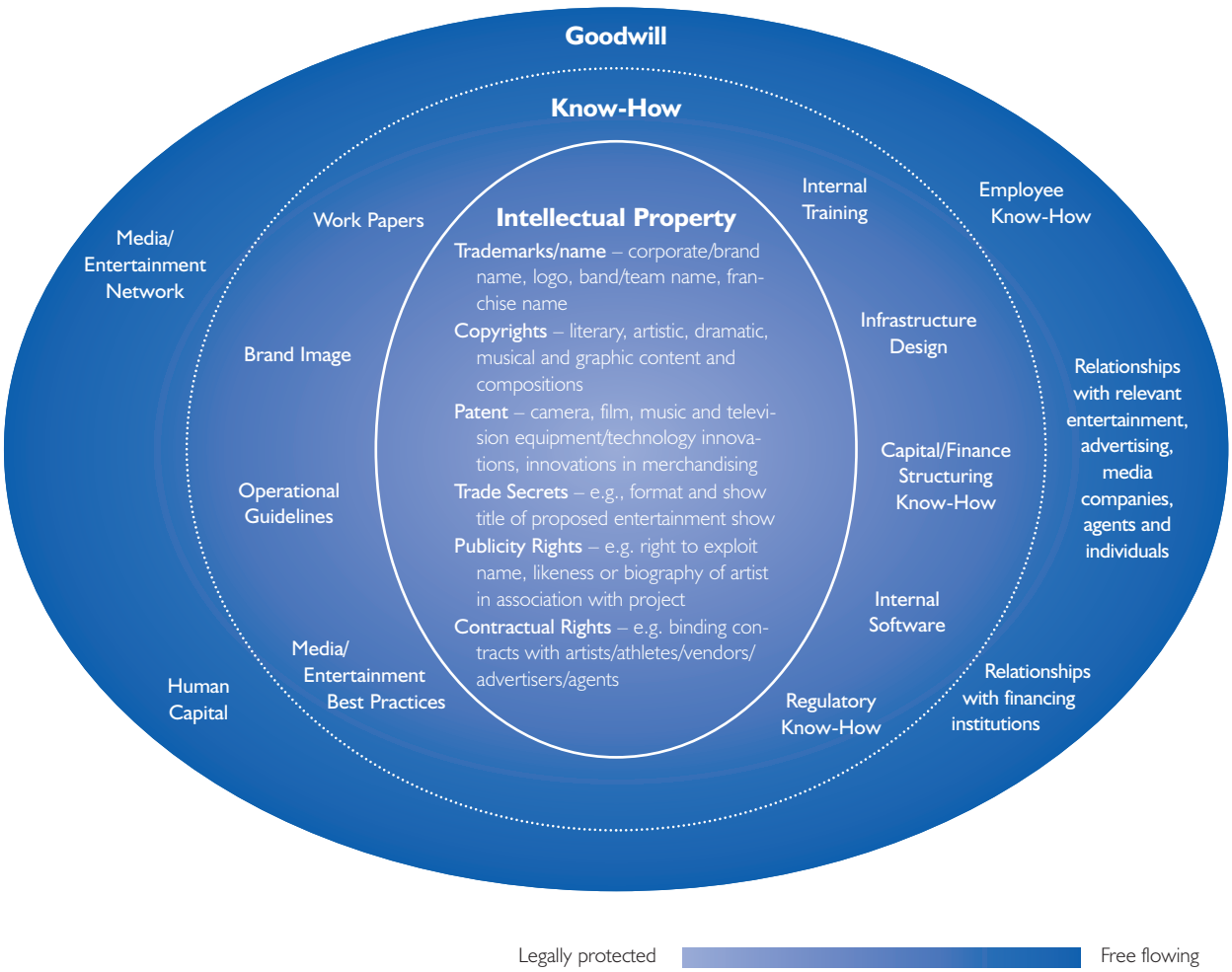
What types of IP are important for media and entertainment companies?

Intangible assets are frequently difficult to define precisely and can include both legally protected forms of intellectual property (IP) and the more ambiguous, but no less valuable, know-how and goodwill, as demonstrated in Diagram 1.

For US transfer pricing purposes, US Treas. Reg. §1.482-4(b) defines an intangible as an asset that comprises any of the following items and has substantial value independent of the services of any individual:

- Patents, inventions, formulae, processes, designs, patterns, or know-how;
- Copyrights and literary, musical, or artistic compositions;
- Trademarks, trade names, or brand names;
- Franchises, licenses, or contracts;
- Methods, programmes, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data; and
- Other similar items. For purposes of section 482, an item is considered similar to those listed in this section if it derives its value not from its physical attributes but from its intellectual content or other intangible properties.

Diagram 1: Types of intangible assets



Intangibles permeate each stage of the media and entertainment supply chain, from idea conception to content production, marketing, merchandising, distribution, packaging, and delivery.

For example, binding contracts with producers, actors, athletes, musicians, or other personalities, the know-how to structure upfront financing for the production, and the goodwill built up with financial institutions to raise the required capital are all critical to the financial success of movies and TV shows. With the increasing importance of digital content, libraries of proprietary software source code related to videogames, online media, and mobile applications are also increasingly valuable.

Once content is created, it must be marketed to spark the interest of both the distribution channels and end viewers, ensuring diverse streams of revenue going forward. These marketing activities may include ad campaigns, cobranding, theater launches, and merchandising. Success at this stage largely hinges on access to an extensive media and entertainment network, brand image, and relationships and contracts with vendors, advertisers, and personalities. And of course, merchandising deals are impossible without the rights to make and sell merchandise and to use the characters and any associated likeness, artwork, packaging, name, and logos.

Content is then distributed via a number of channels such as movie theaters, television broadcasting, retail locations, and the internet. A company's ability to distribute its content hinges on competing for, and securing the rights to, for example, license and distribute the content to third parties and

Diagram 2: Diversified operations & assets of major media and entertainment companies

COMPANY	A	B	C	D	E	F	G	H
Basic Cable Network(s)	●	●	●		●	●	●	●
Billboards/Posters	●							●
Book Publishing	●	●	●	●				
Broadcast TV Network(s)	●	●	●			●		●
Broadcast TV Station(s)	●	●	●					●
Film Production/Library	●	●	●		●	●	●	●
Internet/Broadband Sites	●	●	●	●	●	●	●	●
Magazines/Newspapers		●		●		●		
Merchandising	●	●	●		●	●	●	●
Premium Cable Network(s)	●					●	●	
Radio Stations/Networks	●	●						
Recorded Music Label(s)		●			●			
Theme Parks/Resorts		●	●					
TV Production/Library	●	●	●		●	●	●	●

Note: some relatively minor operations may be excluded. Includes significant equity interests in joint ventures or other companies.
Source: S&P Capital IQ Equity Research

having access to a strong distribution network, whether through direct ownership or relationships established with other distributors of content and institutions used to sell content (restaurants, sports leagues, print publications, website owners).

Finally, before the content can be exhibited via the various distribution channels, it often has to be packaged into complete branded channels, localised, combined with scheduled advertising, and transformed into the appropriate local format. Each of these steps requires the use of valuable intangible assets such as local insight about how to put together a channel to attract local audiences, the know-how and software to convert music, movies and television into different electronic formats, as well as the right to advertise on television, movies, radio, online media, and mobile applications.

As shown in Diagram 2, the largest media and entertainment companies straddle more than one stage of the supply chain and operate multiple businesses. Thus, these companies are better positioned to utilise multiple means of marketing to promote their products and attractions. The larger, more established companies enjoy other advantages as well. Larger companies in the filmed entertainment industry, for instance, have the ability to diversify their risk by developing a variety of projects and establishing stronger relationships with theater owners and TV networks. Larger companies also benefit from increased brand-name recognition, management experience, relationships with creative talent, and product distribution capabilities. The above factors contribute to the six largest film distributors making up 80% of US domestic box office revenues, according to Standard & Poor's Industry Surveys: Movies & Home Entertainment, September 13, 2012. For tax and transfer pricing professionals this structure frequently results in complex compensation structures reflecting the interplay of multiple categories of intangible assets that contribute to the overall success of the business.

Typical transfer pricing structure

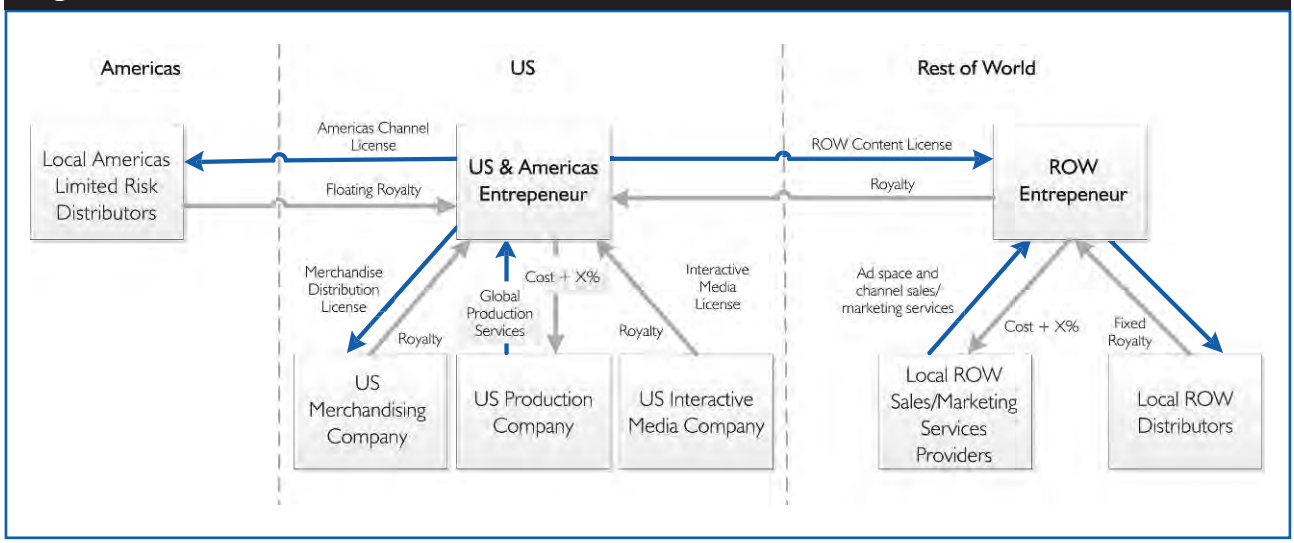
Diagram 3 shows a simplified example of a typical vertically integrated, US-based television production and distribution company, the international affiliates of which distribute content globally. Similar transaction flows are also common for movie studios.

The key functions, risks, and intercompany transactions of each entity type in this structure are described below.

US and Americas entrepreneur

This entity houses the key global strategic decision-making functions, determining what content is produced and bearing

Diagram 3



the related risk. It owns the global brands, content, and other related intangible assets, engaging an affiliate to produce the content on a contract basis. For the US and sufficiently similar markets, such as the Americas, it packages the content into channels that are licensed to affiliates for distribution. For other markets that require more localisation, it licenses the content to be packaged locally.

US production company

This entity engages in content production activities on a contract basis for the US and Americas entrepreneur, either by performing the production activities or outsourcing them to a third party. From a transfer pricing perspective, those services are commonly compensated by reimbursing the cost incurred by the affiliate internally plus an arm's-length mark-up on the costs. Because any fees paid by the US production company to a third party are presumed to be at market price, no additional mark-up is applied to third-party costs.

US merchandising company

This entity engages in the US licensing and distribution, directly or through unrelated parties, of items related to the produced content. From a transfer pricing perspective, there is a payment, usually in the form of a royalty or license fee, from the merchandising company to the content owner.

US interactive media company

This entity provides an interactive gaming and entertainment platform. For example, there could be a cross-platform gaming initiative whereby characters will interact from a console game to multiple mobile and online applications. From a transfer pricing perspective, there is a payment, usually in the form of a royalty or license fee, from the US interactive media company to the content owner.

Local Americas limited-risk distributors

These entities license the complete packaged channels from the US and Americas entrepreneur and distribute them in their local country market. The affiliates collect payment from local third-party customers, retain a portion of the revenue targeting a predetermined arm's-length return, and remit the remainder of the revenue in the form of a floating royalty to the channel licensor. Limited-risk distributors have no control over the composition of the channels and generally execute the centrally developed marketing strategy, with some adaptation to local market conditions.

Rest of the World (ROW) Entrepreneur

This entity drives, funds, and conducts business operations outside the US and Americas region and houses the key ROW strategic decision-making functions, determining what content is licensed and bearing the related risk. This entity licenses ROW rights to the brands, content, and other related intangible assets, and may create central channels for some ROW markets, engaging local ROW sales/marketing service providers in such markets. In other markets, often ones requiring more substantial customisation of content mix, the ROW entrepreneur may sublicense the content rights to local ROW distributors.

Local ROW sales/marketing service providers

These entities provide sales and marketing services to the ROW entrepreneur in the local markets where the ROW entrepreneur is able to sell the centrally packaged channels directly to the local broadcasters. The service providers

Biography

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Mark is a partner in the Los Angeles office of Deloitte Tax and leads the firm's transfer pricing service line for the West region.

Mark has more than 30 years of public accounting and private industry experience, primarily in the international tax and transfer pricing areas. He consults with multinational clients on trans-border transactions, assists multinational companies with transfer pricing studies, and consults with clients on restructuring of foreign royalties and other foreign income streams. Mark led the team that successfully negotiated Mexico's first ever transfer pricing ruling.

Mark is a frequent speaker at US transfer pricing conferences such as CITE's Transfer Pricing and International Tax Planning & Compliance, ACI's Transfer Pricing Audits and California Society of CPA's US-Mexico Conference. He also serves as a transfer pricing instructor for Deloitte Tax's various national and international tax training programmes. He has been consistently recognised by *Euromoney Legal Media Group* as one of *The World's Leading Transfer Pricing Advisers*. Mark received his Masters in Business Taxation at the University of Southern California.

may be compensated by reimbursing the cost incurred by the affiliate internally plus an arm's-length mark-up on such costs.

Local ROW distributors

These entities sublicense content from the ROW entrepreneur as well as other third-party sources to create locally customised channels they then distribute locally. The local ROW distributors make strategic business decisions about the composition, sales, and marketing of the channels in their countries, and bear the related risks. They pay a fixed royalty for the rights to distribute the content.

What drives the value of content?

Whether licensing or selling intangible assets, or estimating compensation for a platform contribution transaction in a cost-sharing context, estimating the value of those assets is one of the most controversial and complex areas of transfer pricing. While there are many types of intangible assets used

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Kristine is a Principal in Deloitte's New York office. She has more than 15 years of transfer pricing and international tax experience with Deloitte and spent four years in Deloitte's Washington National Tax Office. Kristine has extensive experience in company financial and quantitative research analysis and industry data analysis in a wide range of industries. She has prepared economic analyses, documentation, planning, competent authority requests and cost sharing studies for clients in the following industries: media and entertainment industry, telecommunications, digital, computer software, semiconductors, publishing, oil and gas upstream and field services sectors, power generation and renewable energy, chemical industries, healthcare and medical industry, financial services, automotive and automotive suppliers, quick service restaurants, travel industries, consumer goods, and commodities industries.

Kristine has with her international background and experience working in Deloitte transfer pricing teams in Copenhagen and London built up an extensive knowledge of global transfer pricing matters. Kristine is the Americas transfer pricing leader of the technology, media & telecommunications industry programme. She assumes the global lead tax partner role for the world's largest container shipping conglomerate, the global lead TP role for a US based media conglomerate and the US lead TP role for the largest European headquartered consumer and industrial goods conglomerate.

Kristine has given numerous speeches and presentations at the American Conference Institute, Tax Executives Institute, BNA, Atlas, Thompson Reuters, CITE, Deloitte Dbriefs and conferences on transfer pricing issues.

Prior to joining Deloitte, Kristine was an international tax manager at Andersen's Copenhagen office. Before joining Andersen, Kristine worked at the European Commission in Brussels in the Cabinet of the Danish Commissioner for Energy and Nuclear Safety.

Education

- Graduate Diploma in Business Administration (Finance), Copenhagen Business School, 2004
- Master Degree in Laws (LL.M), University of Copenhagen, 1997
- Studied for her final major subjects at George Washington University – School of Business, 2004
- Legal studies at the University of Oxford, 1994

Biography

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Anna Soubbotina is a senior manager in the global transfer pricing service line of Deloitte Tax, based in New York. She has seven years of specialised cross-border and multistate transfer pricing experience, and spent two of those years in Deloitte's Washington National Tax Office.

Anna's experience includes managing projects in diverse industries, including the media and entertainment, technology, energy and power generation, chemical, industrial equipment and automation, software, financial services, and healthcare sectors. Anna has a demonstrable track record consulting on a multitude of transfer pricing issues and the preparation of transfer pricing risk assessments under ASC 740, documentation, planning and audit defense studies, including cost allocation and services analyses, tangible and intangible property. Her focus is on intangible assets and cost-sharing projects involving the valuation of intangible assets, derivation of platform contribution payments, and development of royalty rates for the use of intellectual property.

Anna manages and coordinates the preparation of global transfer pricing documentation for many of Deloitte Tax's largest clients, covering as many as 30 jurisdictions. Throughout this process, she determines compliance with the US transfer pricing regulations, as well as consistency with the OECD transfer pricing guidelines. Anna works closely with Deloitte Tax's global network of specialists to bring clients the benefit of deep local country transfer pricing knowledge and experience.

Anna has designed and presented Deloitte training on the following topics:

- Transfer pricing services regulations
- Transfer pricing and FIN 48
- Mutual Funds, A Roadmap of Transfer Pricing
- Introduction to cost sharing
- Intangible assets and CUT searches

Anna earned her Master of Science in Finance from Imperial College (London), and received a Bachelor of Science (Honors) in Economics from the University of St. Andrews, UK.

in the media and entertainment industry, content is the key value driver, a unique characteristic of this space.

The comparability guidance for the application of the comparable uncontrolled transaction method in Treas. Reg. §1.482-4(c) provides that the following factors, among others, are evaluated to determine the comparability of controlled and uncontrolled transactions. It may be inferred that these factors are expected to affect the transactions' market price:

- Profit potential;
- Terms of the transfer, including the exploitation rights granted in the intangible, the exclusive or nonexclusive character of any rights granted, any restrictions on use, or any limitations on the geographic area in which the rights may be exploited;
- Uniqueness of the property and the period for which it remains unique, including the degree and duration of protection afforded to the property under the laws of the relevant countries;
- Economic and product liability risks to be assumed by the transferee; and
- Duration of the license, contract, or other agreement, and any termination or renegotiation rights.

These characteristics are of particular relevance for estimating the value of content. Specific examples from the media industry include:

- Type of agreement: content may be licensed on a "spot" basis, with an individual price and agreement for each movie or TV series, or it may be licensed in bulk with the licensee committing to purchase a minimum amount or even all of a producer's content in a given year.
- Producer: content price may be affected by the past performance, reputation, and strength of the network behind the studio producing this content. A studio with an extensive distribution network may be able to market and launch a show more effectively, attracting more viewers.
- Content quality: the storyline, strength, and celebrity of the actors and directors, as well as the size of the studio's investment all affect the amount of interest a show or movie attracts, in turn driving higher revenues.
- Exclusivity: exclusive licenses are generally considered more valuable, eliminating competition. Industry experience suggests that nonexclusive license rates may be as much as 50% lower than exclusive ones.
- Age of content: newly released content is generally more valuable than older library content.
- Type of content: reality TV shows are significantly cheaper to produce than scripted shows; furthermore, the level of competition and the size of the potential audience reached vary by genre, driving differences in value.
- Popularity: movie popularity is widely evaluated based on box office receipts during an initial period after launch. Unlike movies, television shows do not have standard popularity metrics; however, IMDb, Nielsen, or other similar ratings could be used to gauge popularity. This could also

be indirectly inferred based on when a show is aired: daytime or primetime.

- Exploitation rights granted: there are as many different types of content distribution rights as there are distribution channels, and whether rights to distribute (via mobile devices, free TV, paid TV, electronic sell through, or video on demand) are included may affect price.

The impact of going digital

Sales channels are changing and the distribution of content is no longer tangible. Rather, most content today is distributed digitally and the question becomes how to characterise the local "distribution affiliates" of large media and entertainment conglomerates. Given that their functions remain broadly the same, and the only change has been a shift to digital distribution of content, have they now become service providers? They will no longer need to carry physical inventory, perform warehousing, or coordinate shipments; accounts receivable and accounts payable may be moved to the head office, with local affiliates providing local sales and marketing support. Because characterisation as a service provider typically provides less profit to the local affiliate than a distribution characterisation, this matter should not be neglected. We may expect to see more arguments for leaving a routine service provider return based on a mark-up on cost with the local affiliates in a digital world, and it is hard to see the arguments against the transfer pricing model shifting as the world is digitalising.

Decentralisation

As evident from our example, most content in the media and entertainment industry is produced and owned in the US, with eight of the top 10 global media companies being US based. However, due to the advent of new production technologies, increasing digitalisation of content, and globalisation, production costs and barriers to entry are declining. Even within established media companies, proprietary content can now be produced locally, targeting specific audience demands. The upcoming challenge for such companies will be how to effectively manage intangible assets when these are increasingly created in a decentralised manner across the globe.

Acquisition premiums and cost sharing analysis

In the world of mergers and acquisitions, it is fairly common to observe a difference between the actual price paid in acquiring a target company and the preacquisition fair value of the company, the acquisition premium. Keith Reams, Lawrence Shanda, Joe Tobin, and Wen-Fang Liu analyse the concept.

A public company that has a preacquisition stock price of $50 per share, but is acquired at $60 per share, obtains a 20% acquisition premium. Similarly, a company that has an estimated preacquisition value of $80 million but is acquired for $100 million, enjoys an acquisition premium of $20 million. Although acquisition premiums are simple to calculate, they can often impact a company's financials in nuanced ways.

The presence of acquisition premiums has various implications for both financial reporting and corporate taxation. This article provides an overview of acquisition premiums from a transfer pricing perspective in the context of a cost sharing analysis.

Acquisition premiums and cost sharing arrangements

When a target company is acquired and some or all of its assets are contributed to a cost sharing arrangement (CSA) between the buyer and its affiliate(s), the acquisition price method as defined in IRS Treas. Reg. §1.482-7(g)(5) can potentially be used to determine the value of the platform contribution transaction (PCT) payment among the CSA participants. In particular, the acquisition price method determines the value of the PCT payment as the amount paid to acquire a target company plus its liabilities minus its tangible assets and other assets that are not contributed to the arrangement. An analysis of the acquisition premium is important in the application of the acquisition price method because an acquisition premium often accounts for a significant part of the acquisition price and thus can have a large impact on determining the value of the PCT payment.

Goodwill

The concept of an acquisition premium is closely related to the "goodwill" concept in financial statement valuations. Goodwill accounting is typically carried out through an analysis of the purchase price allocation, or PPA, which allocates the acquisition price/purchase price to various assets and liabilities acquired in the transaction. The PPA calculates goodwill as the difference between the acquisition price and the fair market value of the tangible assets and identified intangible assets. As such, acquisition premiums arising from synergies may fall within the goodwill bucket. Although allocations or other valuations done for accounting purposes are not conclusive for purposes of the best method analysis in evaluating the arm's-length charge of a PCT, they often provide a useful starting point. With respect to the goodwill from an acquisition, further analysis is generally needed to identify the source and nature of the underlying value drivers and the associated legal ownership and benefits in connection with each of the CSA participants.

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Experience

Keith Reams is the US and Global Leader for Clients and Markets for Deloitte's Global Transfer Pricing Services practice. He has advised clients around the globe on intercompany pricing transactions with respect to income tax regulations in Argentina, Australia, Belgium, Brazil, Canada, Chile, China, Colombia, Czech Republic, Denmark, France, Germany, India, Ireland, Israel, Italy, Japan, Korea, Luxembourg, Malaysia, Mexico, the Netherlands, Norway, Peru, Poland, Singapore, South Africa, Spain, Switzerland, Taiwan, Thailand, the United Kingdom, and the United States. He has assisted numerous multinational companies with international valuation and economic consulting services involving merger and acquisition activity, international tax planning, and restructuring and reorganization of international operations. Keith is on the global tax management team for Deloitte's Technology, Media and Telecommunications practice and is a leader in the area of transfer pricing for newly emerging industries, such as electronic commerce and cloud computing, where he has extensive experience around the world in helping clients extend their business models into new territories.

Keith has testified as a qualified expert in numerous valuation and transfer pricing disputes, including the cases of *Nestle Holdings Inc. v. Commissioner*; *DHL Corp. v. Commissioner*; and *United Parcel Service of America, Inc. v. Commissioner*. In addition, he is one of only three economists in the United States approved by the New York State Department of Taxation and Finance to provide transfer pricing expertise and testimony in cases involving cross-border transactions within commonly controlled affiliated groups. He has also helped many clients to successfully resolve valuation and transfer pricing disputes before they reach trial.

Keith completed course requirements for a Ph.D. in International Finance from New York University. He holds a Master of Arts in Economics from California State University Sacramento and a B.S. degree in Chemical Engineering from Stanford University.

Why are there acquisition premiums?

Researchers and practitioners have identified several factors that account for the presence of acquisition premiums. Synergies and control premiums are among the two most commonly identified, and are discussed below.

Synergies

Synergy refers to the potential additional value gained from combining two companies. Synergies occur when the value from the merger of two companies is greater than the sum of the values that would have been achieved if the organisations had not merged. Synergies may be bifurcated into two categories:

Operational synergy

Operational synergies are those synergies that allow companies to reduce their operating costs, increase revenue and growth, or both. An example of operational synergy is achieving economies of scale from buying a customer, a supplier, or a competitor, which allows the combined company to become more cost-efficient and profitable. Revenue growth in new or existing markets may also arise from the combination of two companies through the cross-utilisation of distribution networks, shared customer lists, and/or expanded product offerings.

Financial synergy

Financial synergies arise when the benefits of combining two companies come from higher cash flows, a lower cost of borrowing, or a more favorable tax status. A merger of two companies when one company has a large amount of cash or excess borrowing capacity while the other has high-return projects but lacks project funding can result in financial synergies. A profitable company that acquires a company with accumulated net operating losses may be able to use the latter's NOLs to reduce its tax burden.

Control premium

Control premium refers to the incremental amount an investor will pay to acquire control of a company, typically an amount higher than the company's current market value. The term "control premium" has created some confusion and disagreement among valuation professionals. Some people use the term to represent the overall acquisition premium offered by buyers in taking over a public company, because this premium appears to quantify the value of control. In his analysis of control premium, Nath (2011) distinguished between investment control and management control. He stressed that the mere fact of control does not lead to any specific premium. He explained that because public shareholders have total control over their investment, there is no control premium associated with investment control. Furthermore, management control of a public company resides with the board of directors, and public markets exist to allow investors the opportunity to invest easily in companies without requiring any management skill or management responsibility on the part of the investor. Accordingly, in most cases there is no control premium associated with management control. Cornell (2013) further elaborated that control premiums

exist only when the board of directors and management of a public company operate ineffectively and fail to maximise the value of the company, and commented that in the great majority of situations, there are no control premiums and acquisition premiums are the result of other factors such as synergies.

Analysis of IRS Examination's and IRS Office of Chief Counsel's views on acquisition premiums and relevant court cases

IRS Examination and the IRS Office of Chief Counsel have historically opposed taxpayer valuations that use the acquisition price method to allow for carve-outs of the control premium and other acquisition premiums such as synergies of the acquirer. In these groups' view, if such premiums were paid by the US parent and benefit the US parent, then they also benefit the controlled foreign corporation (CFC) when intangibles related to them are contributed to a CSA. IRS Exam and the Office of Chief Counsel have also challenged an argument that is often put forward by taxpayers in support of such carve-outs: that such carve-outs should be allowed if the acquisition premium represents the "synergies of the acquirer" rather than any inherent value in the intangibles being transferred to the CSA (we will refer to this as View SA).

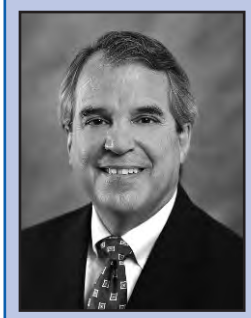
The basic idea behind View SA is that, under the arm's-length standard, the value of the transferred intangibles should be determined without reference to any value the PCT payee (typically the US parent) would be able to add to such intangibles because of its own abilities. Rather, under View SA, the value of such intangibles should be determined by reference to what the US parent would be able to obtain for such intangibles from a midmarket buyer if it had to turn around and sell them on the open market.

IRS Exam and the Office of Chief Counsel have challenged this midmarket approach based on the view that it is inconsistent with their interpretation of the arm's-length standard described in Treas. Reg. §1.482-1(b)(1) (the arm's-length standard). But their interpretation of that regulation has been rejected by both the US Tax Court (*see Xilinx v. Comm'r*, 125 T.C. 37 (2005)) and the Ninth Circuit Court of Appeals (*see Xilinx v. Comm'r*, 598 F.3d 1191 (2010)). Accordingly, taxpayers may consider whether View SA might be appropriate under alternative interpretations of the arm's-length standard. Let us take a closer look at what happened in *Xilinx* to better understand these arguments and how they might apply to the calculation of the acquisition price method.

IRS Examination's and the Office of Chief Counsel's view is based on the idea that the arm's-length standard requires calculation of the PCT payment solely by reference to two amounts – what the controlled seller is willing to accept (given its unique circumstances), and what the controlled buyer is willing to pay (given its unique circumstances). But the Ninth Circuit explicitly rejected this view in the *Xilinx* appeal:

> Section 1.482-1(b)(1) specifies that the true taxable income of controlled parties is calculated based on how parties operating at arm's-length would behave. The language is unequivocal: this arm's-length standard is to be applied in every case. In the context of cost sharing agreements, this rule would require controlled parties to share only those costs uncontrolled parties would share. By implication, costs that uncontrolled parties would not share need not be shared.

Biography



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Lawrence Shanda is a director in the New York office of Deloitte Tax's transfer pricing group, and is the Northeast Region transfer pricing leader for business model optimisation studies. His primary responsibilities include economic consulting relating to transfer pricing and intellectual property issues.

Mr Shanda's experience includes more than 25 years of consulting related to intellectual property and intangible assets. His expertise in this area, which includes the valuation of intellectual property and intangible assets, the development of royalty rates, and the determination of damage calculations, has been provided for reasons such as transfer pricing related to international and domestic planning and compliance projects, infringement litigation, tax purposes, merger and acquisition activity, strategic planning, and bankruptcy proceedings.

Mr Shanda has authored a number of articles on intellectual property, the licensing of intellectual property, and the tax treatment of intangible assets. In addition, he has made numerous presentations on the subjects of intangible assets and intellectual property and intellectual property rights to audiences ranging from an IRS economist training session to the Licensing Executives Society.

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Joe Tobin is a senior manager in global transfer pricing at Deloitte's Washington national tax practice. Joe was the primary drafter of the Treas. Reg. §1.482-7 (2011) Final Cost Sharing Regulations. Joe was previously the senior counsel at the IRS Office of Associate Chief Counsel (International) (Branch 6) (Transfer Pricing) in Washington DC, where he was a reviewer for several high profile transfer pricing litigation cases, including VERITAS, Medtronic, Amazon, and BMC Software. He has spoken at numerous conferences, webcasts, and training sessions on transfer pricing and cost sharing. He has been a member of the Georgetown Law Adjunct Faculty since 2013, where he co-teaches a class on transfer pricing.

This behavioral interpretation of Treas. Reg. §1.482-1(b)(1) (which looks to how uncontrolled parties behave) is at odds with IRS Exam's and Office of Chief Counsel's interpretation of Treas. Reg. §1.482-1(b)(1), because it does not address the behaviour of uncontrolled parties (who, they admitted in the *Xilinx* litigation, never shared stock option costs); rather, it provides for a construction of value based on a complex econometric analysis of the interaction between the two controlled parties.

The *Xilinx* concurrence explained that even if this view of Treas. Reg. §1.482-1(b)(1) were theoretically possible, the government did not clearly articulate it in its regulations, so the court need not defer to it:

> Although I would not go so far as *Xilinx* in characterising the Commissioner's interpretation as merely a convenient litigating position, we need not defer to it because he has not clearly articulated his rationale until now. Indeed, I am troubled by the complex, theoretical nature of many of the Commissioner's arguments trying to reconcile the two regulations. Not only does this make it difficult for the court to navigate the regulatory framework, it shows that taxpayers have not been given clear, fair notice of how the regulations will affect them. … These regulations are hopelessly ambiguous and the ambiguity should be resolved in favor of what appears to have been the commonly held understanding of the meaning and purpose of the arm's-length standard prior to this litigation.

Thus, following the *Xilinx* concurrence, taxpayers might argue that the IRS Office of Chief Counsel should explain and specify its complex interpretation of the arm's-length standard in detailed regulations before requiring compliance with the interpretation. Accordingly, taxpayers might also contend that they are entitled to follow the Ninth Circuit's behavioural interpretation of the arm's length standard, rather than what the Ninth Circuit viewed as the IRS Office of Chief Counsel's complex, unarticulated interpretation.

Assuming that taxpayers may rely on such a behavioural interpretation of the arm's-length standard (at least until such time as IRS Office of Chief Counsel articulates its more complex view of Treas. Reg. §1.482-1(b)(1)), what are the consequences of applying such a behavioural interpretation to the acquisition price method? The behavioural interpretation of the arm's-length standard, when applied to the acquisition premium carve-out issue, could require that the PCT payment from the PCT payor (typically the CFC) to the PCT payee (typically the US parent) be based on what the value of the intangibles would be on the midmarket price in an open market (that is, finding the midmarket price when considering a whole range of possible sellers versus a whole range of possible buyers) rather than on what the PCT payor would pay for them given its unique circumstances. In other words, the PCT payment could be based on the inherent value of the intangibles rather than any value that any specific PCT payor or any specific PCT payee is able to bring to the situation to increase their value. Hence, under this view, the control premium or acquisition premium may be carved out of the acquisition price to arrive at the inherent value of the intangibles.

This result may be especially warranted when the PCT payor has already paid the PCT payee for various items that would create the synergies that must be carved out. This idea was persuasively explained in Chandler and Foley (2010), which demonstrates how the acquisition price method results in double counting (compared to the income method) in situations whereby the PCT payor has already paid for certain items, such as a trademark royalty or routine operating costs, and thus owns the synergies attributable to those items. The Chandler and Foley article was treated as a comment on the 2008 temporary cost sharing regulations, and the IRS and Treasury Department acknowledged the validity of the reasoning in the article in the preamble to the 2011 final cost sharing regulations:

> Comments were received that, with some acquisitions, there may be benefits to the controlled group whose scope extends beyond the development of cost shared intangibles. The Treasury Department and the IRS agree that these facts and circumstances should be taken into account in the appropriate application of the acquisition price method and any other methods for purposes of determining the best method….
> ~ *Federal Register*, Vol. 76, No. 246 (December 22, 2011), p. 80085.

Thus, the government has acknowledged the validity of the "Chandler-Foley carve out" from the acquisition price method for synergies attributable to other items the PCT payor has already paid for previously. The PCT payment must focus solely on the value of the cost shared intangibles by themselves, not on anything that extends beyond their scope.

It remains to be seen whether the courts will agree with the reasoning behind the "Chandler-Foley carve-out," but since the rationale is similar to the other carve-outs discussed above, taxpayers may be able to argue that they are entitled to carve out such synergies from the acquisition price method.

Identify the source and nature

To analyse the acquisition premium in an application of the acquisition price method, it is important to identify the source and nature of the acquisition premium, especially those acquisition benefits to the controlled group whose scope extends beyond the development of cost shared intangibles.

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Biography

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Wen-Fang works with multinational companies in developing intercompany pricing strategies on a variety of transfer pricing assignments, including IP planning, global supply chain planning, audit defense, and global documentation. Wen-Fang has more than 10 years of experience in leading and managing intellectual property planning studies and global transfer pricing documentation projects, and implementing and modifying global transfer pricing policies to support clients' overall business and tax objectives. She has served major clients in the industrial equipment, technology, automotive, medical device, pharmaceutical, and financial services industries, among others. Wen-Fang speaks at numerous tax conferences.

Before joining Deloitte, Wen-Fang was an Assistant Professor of Economics at the University of Washington. In that function, Wen-Fang taught undergraduate and graduate Macroeconomics courses, gave seminar presentations at universities and Federal Reserve banks, and published a number of articles in leading Economics journals.

Wen-Fang holds a Ph D. in Economics from the University of Chicago.

International tax issues and cloud computing

Cloud computing is not only revolutionising the way companies conduct business, it is also raising questions as to how cloud-based businesses should be taxed. Ron Saake and Mandana Malone provide clarity on the issue.

Guidance on the tax implications of cloud computing is scarce. Taxpayers and tax practitioners alike are left looking to current law in analysing and analogising the tax implications of a virtual business against that of a bricks and mortar one.

The most common income tax issues companies engaged in cloud-based transactions face are income characterisation, source of income, nexus, and allocation of profits to different activities. Indirect tax issues also arise, but are not the subject of this article.

What is the cloud anyway?

People are often confused by references to the "cloud". Cloud computing, or the cloud, is a set of technologies that allow for the remote delivery of on-demand computing resources over a network, such as the internet, usually on a pay-for-use basis. Several recognised service models exist for cloud computing: software as a service (SaaS), infrastructure as a service (IaaS) and platform as a service (PaaS). In all three of these models, the user generally does not have control, possession, or any interest in the cloud infrastructure or software used.

Character of income

Perhaps the most critical tax detail with respect to cloud computing transactions is determining the character of income resulting from such transactions. The character of income (service, rent, or royalty) earned by a taxpayer directly impacts how such income is sourced and taxed under the laws of many countries, including the US. It is not always clear whether the character of income derived from contracts within the realm of the cloud computing industry constitutes rents, royalties, or services income.

For US tax purposes, IRC §7701(e) and Treas. Reg. §1.861-18 are relevant in making that determination with respect to cloud-related services, such as hosted offerings. Before discussing whether the character of the income in question may be services or rents under §7701(e), it is important to consider Treas. Reg. §1.861-18.

Treas. Reg. §1.861-18

Cloud computing transactions generally do not fall under the purview of the regulations promulgated in Treas. Reg. §1.861-18. These regulations are relevant only to transactions involving the transfer of computer programs or the transfer of rights to such programmes. Treas. Reg. §1.861-18(b). In cloud computing models, users typically get access to application development tools or the use of software, but do not receive copies of programs or software. For instance, SaaS companies do not deliver software and simply permit users access to their software. The SaaS business model is built on the reality that the SaaS company maintains and operates the software for

its customers and keeps it under its control. The customer does not have physical possession, or even constructive possession, because constructive possession would require the exercise of control over the software and clearly that does not exist, because SaaS companies grant multiple users concurrent access to the same version of their software.

The paramount task then in determining the character of income from cloud computing transactions becomes distinguishing between whether a transaction results in a lease or the provision of services. IRC §7701(e) is relevant to making that distinction.

IRC §7701(e)

For US tax purposes, a contract that purports to be a service contract may be recharacterised as a lease of property if the following requirements of §7701(e) are met:

1) The service recipient is in physical possession of the property;
2) The service recipient controls the property;
3) The service recipient has a significant economic interest in the property;
4) The service provider has no economic risk in the contract;
5) The service provider does not provide services to a third party; and
6) The contract price does not "substantially" exceed the rental value of the property.

If these factors are present in a contracting arrangement, then the income derived from that arrangement is more likely to be rental income. In the alternative, if the factors are not present in a contractual arrangement, then it is more likely the agreement will be characterised as a service agreement, giving rise to service income. It is important to note that not all six requirements must be satisfied to have a lease or service contract. Section 7701(e) does not assign greater significance to any of the criteria, but simply allows for a contract either resembling a lease or a service contract. Notwithstanding the outcome of some case law to the contrary, it can be said that a simple majority of criteria is necessary for classification.

In considering the list of requirements, it is clear that at least the first three, for example are not met in a typical cloud computing transaction, because the user of the cloud services is not in possession of the software or infrastructure, does not control them, and does not have an economic interest in the property at issue. For these reasons, cloud computing transactions generally will be considered to generate services income for US tax purposes. Our experience indicates that the same conclusion will be reached under the laws of most countries.

Source of income

With the character of income determined, sourcing that income becomes relevant. Generally, the US sources income based on the type of transaction that gives rise to it. IRC §861(a), 862(a). For instance, income from the performance of personal services is sourced to the location where those services are performed (IRC §861(a)(3)) and income from the use of intangible property (royalty income) is sourced to the location where the property is used. IRC §861(a)(4).

However, where should services rendered with little human involvement be deemed to be performed? The source of income in connection with cloud-related service offerings has not been addressed in the existing legal authorities. Thus, taxpayers are left to draw analogies to cases involving brick and mortar businesses.

In *Piedras Negras Broadcasting Co. v. Commissioner,* affirmed by the Fifth Circuit in *Piedras Negras Broadcasting Co. v. Commissioner,* 127 F.2d 260, at 261 (5th Cir. 1942) the Tax Court looked to the location of broadcasting equipment (as in capital) and personnel (as in labour) in making its determination as to the situs of the taxpayer's income-producing

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Ron is an international tax partner with Deloitte in San Francisco and San Jose. Ron has been a tax practitioner since 1986 and became a partner with another international accounting firm in 1996. He has worked in the international tax area his entire career.

Ron works with both public and private companies in structuring new international operations and in enhancing ongoing operations. He has significant experience in mergers and acquisitions, planning involving intangible assets, and structuring to help companies reduce their global tax burden. Ron has deep knowledge and experience in tax accounting matters (ASC 740). His clients are in many industries, with a focus on technology companies. He is a frequent speaker on international tax matters, involved with groups such as ATLAS, the Council of International Tax Executives, and the Tax Executives Institute. For the last several years, Ron has been recognised by Euromoney and the Legal Media Group as one of the world's leading tax advisors.

Ron graduated from the University of California at Berkeley with an MBA in 1985 and from the University of California at Riverside with a BS in Administrative Studies in 1982. He is a California CPA.

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She has 10 years of experience in international tax working with both public and private companies in structuring their new international operations and in enhancing ongoing operations. In addition to financing and restructuring transactions, Mandana has significant experience with international tax issues within the realm of e-commerce.

Mandana graduated from the Washington University School of Law with a J.D. and from St. Louis University with a B.S. in International Business. She is a member of the California Bar.

activities, and found that the situs of the taxpayer's advertising services was the location of its broadcasting facilities in Mexico. 43 B.T.A. 297 (1941). The Fifth Circuit Court stated that the source of income is the "situs of the income producing service" meaning "the services required by the taxpayers under the contract." 127 F.2d at 260-61. The location of the broadcasting company's audience was not a pertinent factor in determining source.

The *Piedras* case serves as useful guidance in determining the source of income from internet activities, including cloud computing transactions. *Piedras* confirms that the "situs of the income producing service" is the key factor to determine the source of income from the remote provision of technology, and that the situs of service income can be the location of the equipment.

Cloud computing and the right to tax

Whether the servers from which cloud computing transactions are offered create a taxable presence for a foreign corporation must be analysed on a case-by-case basis. However, the permanent establishment langauge in OECD treaties and the related model treaty commentary offers some guidance.

Permanent establishment

Income tax treaties, if applicable, present a set of rules to determine whether the presence of a server from which a foreign corporation delivers services to customers creates US tax nexus. Generally, a company resident in a treaty country may be taxed only on business profits in the other treaty country if the company has a PE in the other country and profits are attributable to that PE. A foreign corporation is generally treated as having a PE only if: (1) it maintains a fixed place of business in the other country, or (2) the activities of another person are imputed to the foreign corporation.

When a company's sole activity in another country is the maintenance of servers in a cloud computing business, the question is whether a PE arises in that other country. OECD Model Tax Convention on Income and on Capital 2008. A server on which software or a web site is stored may constitute a "fixed place of business." Commentary to OECD Model Tax Convention, article 5, paragraph 42.2. Conversely, software or an internet web site (a combination of software and electronic data) do not in and of themselves constitute tangible property and thus cannot have a location that constitutes a "place of business" as there is no "facility such as premises" as far as the software and data constituting that web site are concerned. In addressing this, the OECD model treaty commentary states:

> "…. it is common for the web site through which an enterprise carries on its business to be hosted on the server of an internet service provider (ISP). Although the fees paid to the ISP under such arrangements may be based on the amount of disk space used to store the software and data required by the web site, these contracts typically do not result in the server and its location being at the disposal of the enterprise… even if the enterprise has been able to determine that its web site should be hosted on a particular server at a particular location…. In these cases, the enterprise cannot be considered to have acquired a place of business by virtue of that hosting arrangement. However, if the enterprise carrying on business through a web site has the server at its own disposal, for example it owns (or leases) and operates the server on which the web site is stored and used, the place where that server is located could constitute a permanent establishment of the enterprise if the other requirements of the article are met."
> *~ Commentary to OECD Model Tax Convention, para. 42.3-4*

Thus, in general, if the server on which the software or web site resides is owned by others and is not at the taxpayer's disposal, it is unlikely that a PE will be found to exist. Conversely, if the server is at the taxpayer's disposal, there will be a fixed place of business and a PE.

Transfer pricing and allocation of profits

We are not aware of any transfer pricing guidance in any jurisdiction specific to cloud computing service models.

Thus, regular transfer pricing principles should be applied, including the notion that profit is allocated based on functions, assets, and risks. As described above, in cloud computing service models, tax guidance has generally placed the most importance on the operation of the software on the servers, as opposed to any sales or maintenance activity carried on by humans. Absent other guidance, this would seem to be a significant consideration in the allocation of profits among activities.

OECD on base erosion and profit shifting (BEPS)

We have all by now heard of BEPS and its potential impact on the digital economy, which includes cloud computing. The OECD, at the prompting of the G20 finance ministers, developed an action plan to address various BEPS activities noted in the international economy. The report identified actions to be implemented to counter BEPS, the first of which addresses the tax challenges of the digital economy. In describing Action 1, the report states:

> "Issues to be examined include, but are not limited to, the ability of a company to have a significant digital presence in the economy of another country without being liable to taxation due to the lack of nexus under current international rules, the attribution of value created from the generation of marketable location-relevant data through the use of digital products and services, the characterisation of income derived from new business models, the application of related source rules, and how to ensure the effective collection of VAT/GST with respect to the cross-border supply of digital goods and services. Such work will require a thorough analysis of the various business models in this sector."

No further elaboration on this action exists, and a report is not expected until September 2014. While the findings of this report will not be known for some time, one thing is certain: The international community has taken notice of the anomalies presented in the digital economy and is looking through the stratus for more concrete guidance.