

International

Valuation of Intangibles under Income-Based Methods – Part II

Jens Wittendorff [*]

Issue: 2010 (Volume 17), No. 6

Published online: 27 October 2010

This article, the second of two parts, considers the use of income-based methods to determine the arm's length value of intangibles. Part I was published in the previous issue of the *International Transfer Pricing Journal*.

Introduction

This article explores the use of income-based methods to determine the arm's length value of intangibles. Part I of the article (Part 1) published in the previous issue of this journal, compared the arm's length principle and other valuation standards, provided an overview of the prevailing valuation and transfer pricing methods, discussed the use of income-based methods in transfer pricing and examined the existing income-based methods. Part II will analyse and compare newly introduced income-based methods under the domestic tax laws of the United States, Germany and Denmark, as well as the OECD Guidelines (see 6.), and will examine non-arm's length taxation approaches to the valuation issue of intangibles (see 7.).

6. New Income-Based Methods

6.1. US tax law

6.1.1. General

Under US tax law, income-based methods are recognized as unspecified methods for arm's length tests of contributions that enhance the value of intangibles owned by other taxpayers. [122]

An income-based approach is also adopted in order to evaluate the profit potential of an intangible under the comparability test of the comparable uncontrolled transaction method. [123] It is emphasized that the direct approach may be impractical where it is difficult to calculate the profit potential of a specific intangible. [124] This is illustrated by an example on the transfer of an intangible that relates to one component of an asset consisting of many components, such as an aeroplane or an automobile. In such a situation it would be difficult to calculate the present value of the profit attributable to the subject intangible reliably, as the profit attributable to the intangible will be difficult to isolate from the overall profit attributable to the final asset. [125]

6.1.2. Cost sharing

The 2008 cost sharing regulations specify an income-based method (the income method) for the evaluation of buy-in payments for existing intangibles and other platform contributions. The cost sharing regulations are of interest outside their core area of application, as they reflect the position of the US Internal Revenue Service (IRS) on key issues concerning the valuation of intangibles. This is emphasized by the regulations' stating that the principles, methods, comparability and reliability considerations of the cost sharing rules are relevant for the evaluation of non-conforming arrangements for the development of intangibles. [126] As a consequence, the principles of the cost sharing regulations have been extended to other arrangements for sharing the costs and risks of developing intangibles covered by the regulations on intangibles and services.

The use of the income method is confined to cases where only one participant makes non-routine platform contributions to a cost sharing arrangement (CSA). [127] Similarly, if a participant employs non-routine operating contributions in its business (such as marketing intangibles and manufacturing process intangibles), [128] the residual profit split method may qualify as the best method. [129] The IRS is of the view that the income method generally constitutes the best method for evaluating the arm's length nature of charges for self-developed platform contributions which are provided at the inception of a cost sharing arrangement. [130]

The income method evaluates the arm's length nature of a buy-in payment by reference to a participant's best realistic alternative to entering into the cost sharing arrangement. [131] The buy-in payment is determined as the present value of a participant's cost sharing alternative minus the present value of its best realistic alternative.

The regulations provide that the best realistic alternative of the platform contribution transaction payer (transferee) is generally to license the intangibles to be developed by an uncontrolled licensor that bears the entire risk of intangible

development which would otherwise have been shared under the cost sharing arrangement. [132] Similarly, the best realistic alternative for the platform contribution transaction payee (transferor) is generally to bear the entire risk of intangible development that would otherwise have been shared under the cost sharing arrangement and to license the resulting intangibles to an uncontrolled licensee. Taxpayers may demonstrate that other alternatives would be more appropriate. The income method thus involves the determination of the arm's length price of a transfer of ownership of an intangible on the basis of the arm's length price of the transfer of a right to use the intangible. This may cause a distortion of the income allocation. [133]

The transferee's cost sharing alternative corresponds to the actual cost sharing arrangement. [134] The transferee's licensing alternative is based on a functional and risk analysis of the actual cost sharing alternative, but with a shift of the risk of the cost contributions to the licensor. [135] Accordingly, the licensing alternative consists of licensing the make/sell rights in intangibles of the licensor to be developed subsequently under the same contractual terms and risk allocation as those under the actual cost sharing arrangement. The present value of the transferee's licensing alternative may be determined under the comparable uncontrolled transaction method or the comparable profits method. [136] Both applications mean using a one-sided test with the transferee as the tested party. [137] The income method under the cost sharing regulations corresponds to the incremental income method in corporate finance (see Part I 3.1).

Under the application based on the comparable uncontrolled transaction method, the present value of the licensing alternative is determined as the present value of the stream of the expected profits that would be achieved under the cost sharing alternative, minus operating cost contributions that would be made, and minus the licensing payments as determined under the comparable uncontrolled price method. [138]

Under the comparable profits method-based application, the present value of the licensing alternative is determined similarly, except that the transferee's licensing payments are determined as a lump sum as of the date of the buy-in transaction, equal to the present value of the stream of the profits that would be achieved under the cost sharing alternative, minus operating cost contributions that would be made, and minus market returns for routine contributions. [139]

The income method is illustrated by an example concerning USP, a US software company that has developed version 1.0 of a new software application. Version 1.0 is currently being marketed. In Year 1, USP enters into a cost sharing arrangement with its wholly owned foreign subsidiary, FS, to develop future versions of the software application. Under the cost sharing arrangement, USP will provide a platform contribution to the cost sharing arrangement, whereas FS will not provide any platform contributions. It is expected that FS will have gross sales of USD 1,000 for five years from its exploitation of version 1.0 and the cost-shared intangibles. After this time, the software application will be rendered obsolete and unmarketable. FS's costs attributable to the cost sharing arrangement, other than cost contributions and operating cost contributions, are expected to be USD 250 per year. Certain operating cost contributions that will be borne by FS are expected to equal USD 200 per year. In addition, FS is expected to pay cost contributions of USD 200 per year under the cost sharing arrangement. FS concludes that its realistic alternative would be to license software from an uncontrolled licensor that would bear the entire risk of the software development. Applying the comparable profits method, FS determines that it could, as a licensee, expect a (pre-tax) routine return of 14% of gross sales, or USD 140 per year. The remaining net revenue would be paid to the uncontrolled licensor as a licence fee of USD 410 per year. FS determines that the discount rate that would be applied to determine the present value under the licensing alternative would be 12.5% as compared to the 15% discount rate under the cost sharing arrangement. FS also determines that the tax rate applicable to it will be the same in the licensing alternative as in the cost sharing arrangement.

On these facts, the present value to FS of entering into the cost sharing arrangement alternative and the licensing alternative as well as the buy-in payment may be calculated as follows:

	Cost sharing	Licensing
gross sales	1,000	1,000
costs	(250)	(250)
operating cost contributions	(200)	(200)

cost contribution to CSA	(200)	–
royalty	–	(410)
operating profit	350	140
present value:		
cost sharing alternative; 350, in 5 years, at 15%	1,349	
licensing alternative; 140, in 5 years, at 12.5%	(561)	
buy-in payment	788	

This example shows that the income method means that the buy-in payment will be an amount that causes the present value of the transferee's expected profits to correspond to the expected profits of a licence arrangement, adjusted for the effect of the application of a higher discount rate.

The regulations provide supplementary guidance which should be considered in conjunction with the income method. [140] The core of the supplementary guidance is the realistic alternatives rules and the investor model.

Under the rules on realistic alternatives, the application of a method is deemed to be unreliable where, at the date of the buy-in transaction, for any participant the total expected present value of its profits attributable to entering into the cost sharing arrangement is less than the total expected present value of the profit that it could achieve through an alternative arrangement realistically available to it. [141] The concept of realistic alternatives should, in principle, be applied to all participants. A transferor will normally have more realistic alternatives to a cost sharing arrangement, whereas a transferee, with limited functions and capabilities and without its own valuable intangibles, may have no realistic alternatives to accepting or declining participation in the cost sharing arrangement. On this basis it must be expected that, in practice, the concept will be applied as a one-sided test with the transferor as the tested party. [142] Given the normal structure of cost sharing arrangements, the transferor will be a US parent company. [143] A realistic alternative for a parent company may be to undertake the intangible development activity itself and subsequently conclude licence agreements with its foreign subsidiaries. [144] This is the realistic default alternative of the regulations. [145] If a license alternative will provide a parent company with an expected present value that exceeds the expected present value of the cost sharing arrangement alternative, the buy-in payment must be increased to balance out the difference. The concept of realistic alternatives will normally have the effect of establishing a minimum expected rate of return for the transferor and a lower limit for the buy-in payment. [146]

The investor model is based on three concepts:

- an ex ante valuation of buy-in intangibles;
- an assumption that the expected rate of return of the cost sharing arrangement should equal the appropriate discount rate; and
- an assumption that the useful life of any contributions to the cost sharing arrangement activity lasts for the entire expected period of development and exploitation.

The investor model aims at providing answers to the following questions:

- What would an investor pay at the outset of a cost sharing arrangement for an opportunity to invest in the arrangement?
- What would a participant with platform contributions require as compensation at the outset of a cost sharing arrangement to allow an investor to join the investment? [147]

The answers to these questions are framed as an assumption that each participant's aggregate net investment in the cost sharing arrangement activity is reasonably expected to earn a rate of return equal to the appropriate discount rate for the participant's cost sharing arrangement activity over the entire period of the activity. [148] The investor model thus entails that the expected present value of the cost sharing arrangement activity should be zero. The tested party will

normally be the transferee. This establishes a maximum rate of return for the transferee equal to the appropriate discount rate for the cost sharing arrangement activity and a lower limit for the buy-in payment. The premise that the present value should be zero is unfortunate if a platform contribution is of limited value, as that will blur the correlation between the platform contribution and the cost sharing arrangement profits. [149]

The income method is based on the axiom that the risks associated with future research activities (cost contributions) cannot be placed on a par with the risks associated with past research activities (platform contributions). Hence, a participant that makes only cost contributions is not entitled to share in any non-routine profits if another participant makes a non-routine platform contribution.

The income projections should reflect the best estimates of the items projected – normally reflecting a probability weighted average of possible outcomes. [150] Taxpayers are generally considered to be in the best position to make projections of likely results from cost sharing. [151] The IRS should therefore be reluctant to substitute its own judgment for the reasonable application of the judgment of taxpayers. [152] However, the IRS is entitled to make adjustments to improve the reliability of projections. [153]

The discount rate of the cost sharing alternative and the licensing alternative should reflect the market-correlated risks of each alternative. [154] The temporary regulations have eliminated the references to a weighted average cost of capital or hurdle rate contained in the proposed regulations as unnecessary, but without any implication as to a weighted average cost of capital or hurdle rate being an appropriate discount rate. [155]

A present value analysis should, in principle, be based on the application of post-tax discount rates to post-tax income. [156] However, a post-tax discount rate may be applied to pre-tax income if a conversion of the result on the basis of the tax rate yields the same result as a calculation based on post-tax income. A buy-in payment must generally be determined on a pre-tax basis. [157] Accordingly, if the present value has been determined on the basis of post-tax income, it is necessary to make an adjustment in order to arrive at an arm's length value of the buy-in payment on a pre-tax basis.

The arm's length test of an existing intangible should consider the right to exploit both the cost-shared intangible and future generations of cost-shared intangibles, provided that the platform contribution is reasonably expected to benefit the development of such future generations. [158] The regulations are based on a fundamental distinction between make/sell rights [159] and platform rights. [160] Further, the regulations provide that a method is less reliable if it assumes a useful life for any existing intangible that does not last for the entire expected period of development and exploitation. [161] The regulations imply a change of position, as the IRS has previously acknowledged that it could be appropriate to apply a declining-royalty method due to the replacement of existing intangibles with cost-shared intangibles. [162]

Under the regulations, the present value is determined on the basis of income (operating profits). However, the preamble clarifies that the income method is theoretically based on valuation techniques which use cash flow projections rather than income projections, and that the use of cash flow is permitted. [163] The regulations also provide that transactions involving platform contributions may be so interrelated that an aggregation of the transactions will provide the most reliable measure of an arm's length test. [164]

The general rules on arm's length ranges are applicable to the evaluation of a buy-in payment. [165] The cost sharing regulations provides additional guidance on arm's length ranges applicable to methods that are based on two or more input parameters the values of which depend on the facts of the case. [166] For example, if the best method is the income method, and if there are three different discount rates within the interquartile range of discount rates, and three different profit margins for routine returns, a total of nine alternative buy-in payments must be calculated. The interquartile range of those nine payment values would then form the applicable arm's length range for the buy-in payment.

6.2. German tax law

German tax law does not provide special arm's length rules for the transfer of intangibles in domestic transactions. [167] On the other hand, cross-border transactions are subject to the mandatory transfer pricing rules of Sec. 1 of the Foreign Tax Act. Under Sec. 1, the nature of the arm's length test of cross-border transactions depends on the availability of reference transactions. If unlimited or limited comparable reference transactions exist, an empirical arm's length test must be made. [168] In the absence of such reference transactions, a hypothetical arm's length test must be made, based on the concept of a "sound and prudent business manager" (*des ordentlichen und gewissenhaften Geschäftsleiters*). [169]

In principle, the arm's length test should be applied separately for each transaction (*Einzelbewertungsgrundsatz*). [170] However, if an intangible is transferred as part of a relocation of functions, and there are no unlimited or limited comparable reference transactions, the law prescribes an aggregated arm's length test of the transfer package (*Transferpaket*) as a whole. [171] This rule is applicable to both a transfer of the ownership of assets and of the right to use assets. The aim of the transfer package concept is to ensure that the valuation includes synergies between the transferred assets, [172] and that all transferred intangibles and business opportunities are identified and subject to

German taxation. [173]

The law contains an exception (*Escape-Klausel*) to the requirement for an aggregated examination which is applicable if the taxpayer substantiates that:

- the transaction does not include significant intangibles;
- the overall result of the separate price determination, as measured by the price for the transfer package as a whole, complies with the arm's length principle; or
- at least one significant intangible is transferred and a precise description is made of this intangible. [174]

Separate arm's length tests of the constituent elements of a transfer package should be made if one of the exceptions is applicable. This is presumably the case even if the arm's length principle would dictate an aggregated arm's length test. [175] Whether an empirical or hypothetical arm's length test should be made depends on the availability of unlimited or limited comparable transactions; see above. The first exception is, for example, applicable if the transferee solely exercises the function with respect to the transferor, and the consideration payable for exercising this function and supplying the corresponding goods or services is properly determined under the cost-plus method or a cost-based transactional net margin method (TNMM). [176] Thus, this exception addresses typical contract manufacturing arrangements.

The hypothetical arm's length test constitutes an income-based method. The law and regulations do not provide detailed rules on the methods that may be used to determine the profit potentials. [177] A Draft Circular states that the profit potentials may be determined under both a direct and indirect approach. [178] A direct approach may be adopted where the expected future benefits associated with an intangible, such as premium pricing or cost savings, are capable of being identified and measured. An indirect approach may be made on the basis of standard income-based methods. The regulations provide that a functional analysis should be made both before and after a relocation of functions for both the transferor and the transferee. [179] This approach corresponds with the incremental income method of corporate finance (see Part I, 3.1.) and involves a four-step process as discussed below.

First, the profit potential (*Gewinnpotenziale*) must be determined under two alternatives, with and without the subject intangible for both the transferor and transferee. [180] The profit potentials should be determined on the basis of a functional analysis and projections and must take into account the actual circumstances, the realistic alternatives of the parties, location savings and synergies. [181] Under the incremental income method, it is crucial to avoid the pitfall of mixing intangible profits and routine profits. [182] For example, the total profit potential of an intangible and an associated routine manufacturing function may be 1,000 for both parties, and the arm's length profits that stem from the routine function may be 200. If the transferor is converted from a full-fledged manufacturer to a contract manufacturer of the transferee subsequent to a transfer of the intangible in question, the difference between the profit potentials, with and without the intangible, will be 800 for both parties (i.e. the transfer price will be 800). On the other hand, if the transferee will perform the routine function itself, the difference between the profit potentials, with and without the intangible, will be 1,000 for both parties. However, in this situation, a transfer price of 1,000 would overestimate the arm's length value of the intangible because it includes the routine profits.

According to a transparency clause (*Transparenzklausel*), the transferor and transferee are assumed to have access to all essential information about the transactions. [183] The internal basis for the decision of a multinational enterprise to undertake a relocation of functions should be decisive in the calculation of the profit potential. [184] The internal basis may be disregarded only if the basis, or the calculations made on it, is clearly erroneous. [185]

An indefinite useful life should be applied unless a more appropriate shorter period can be credibly proven. [186] A definite useful life may, for example, be accepted in the case of a transfer of a patent with a limited period of protection. The rules do not address the question of whether the value of an intangible as a platform for the development of new generations of the intangible should be taken into account. However, in the case of the relocation of functions, the transfer package not only includes the function itself and the transferred assets, but extends to the "associated chances and risks" and "other benefits". The broad scope of the transfer package and the presumption of an indefinite useful life suggest that the value associated with platform rights should be considered.

The profit potentials of the two alternatives must be determined as a cash value calculated on a post-tax basis. The profit potentials must thus be determined on a free cash flow basis. [187] Accordingly, operating profits should be adjusted for taxes, depreciation and amortization charges; changes in net working capital; and capital expenditure. [188] The profit potentials should not be grossed up to arrive at pre-tax values. [189] Moreover, a tax amortization benefit should presumably not be added to the discounted cash flow value, although this is not entirely clear. [190] The present value of tax savings expected to be obtained by relocating intangibles and functions to foreign low-tax countries may thus be subject to German taxation because of the operation of the arm's length range (see below).

Second, the present value of the profit potentials of the two alternatives for both parties must be determined on the basis of functional and risk-weighted discount rates. [191] The discount rates should reflect the actual risk profile of the function and the capitalization period, and should be determined on a post-tax basis. [192] The discount rate may differ between the two alternatives of both the transferor and transferee.

Third, the profit potential is equal to the difference between the present value of the two alternatives for the transferor and transferee, respectively.

Fourth, an arm's length range (*Einigungsbereich*) must normally be established, defined by a minimum price which is equal to the profit potential of the transferor plus the amount of any closing costs, and a maximum price which is equal to the profit potential of the transferee. [193] There is a rebuttable presumption that the arm's length price is equal to the middle value of the range. [194]

6.3. Danish tax law

Under Danish tax law, the aggregated value of the intangibles of an enterprise has traditionally been classified as goodwill. [195] For many years a simplified income-based method developed by the tax authorities based on historical profits has been applied to determine the value of goodwill. [196] Lately, the tax authorities have taken the position that this method is primarily to be used in relation to small and medium-sized enterprises with no significant identifiable intangibles. In 2003, the tax authorities stated that the discounted cash flow method could be used to determine the arm's length price of an intangible. [197] In 2006, an income-based method was recognized in a binding ruling. [198] In 2009, the tax authorities published new valuation guidelines on the transfer of ownership of intangibles and businesses in order to fill the gap for larger companies with significant intangibles. [199] The new guidelines do not address royalty rates. The legal status of the guidelines means that they are not binding for taxpayers or courts. The guidelines are based on corporate finance approaches and generally adhere to guidelines on the valuation of businesses issued by the Institute of State Authorized Public Accounts in Denmark. [200] This is reflected by the focus on the transfer of businesses rather than individual intangibles. The aim is to provide guidelines on the application of the arm's length principle of Sec. 2 of the Danish Tax Assessment Act, which corresponds to the arm's length principle of Art. 9(1) of the OECD Model. However, no real attempt is made to harmonize the corporate finance approaches with the arm's length principle and the OECD Guidelines. On this basis, the guidelines primarily appear as a summary of generally accepted corporate finance approaches.

The guidelines state that the valuation of intangibles may be made under the comparable uncontrolled price method, as a residual value vis-à-vis the total value of a business (excess earnings method) or under the relief-from-royalty method. [201] Although the incremental income method is not mentioned, this should hardly be understood as a distancing from this method. The guidelines do not address how the profits attributable to a specific intangible should be identified under an income-based method. It is generally recommended that income-based methods be applied on the basis of free cash flow. As the focus is on the valuation of businesses, there is no discussion of the useful life of an intangible. However, it is emphasized that an intangible may serve as platform for the development for new intangibles, which may cause the capitalization period to extend beyond that of the useful life of the subject intangible. [202] It is recommended that a terminal value calculation be made on the basis of the long-term nominal growth rate in society (Gordon Constant Growth Model). [203] Applying this approach to the valuation of an intangible would assign a perpetual useful life to the intangible.

The guidelines state that a valuation should, in principle, be made from the perspective of both the transferor and the transferee, and that synergies should be allocated between the parties on the basis of the relative bargaining powers. [204] It is further stated that it is normally impossible to determine the outcome of hypothetical bargaining between the parties. On this basis it is recommended that a valuation be made on the basis of a "hypothetical willing seller and buyer" and an assumption of full information transparency between the associated enterprises. The guidelines assert that this will mean that potential group synergies implicitly will be taken into account regardless of whether the valuation is made from the perspective of the transferor or the transferee. This represents a rather narrow view of the issue based on hypothetical market participants which does not account for the effect of entity specific circumstances such as location savings, synergies from other intangibles owned by the parties and different tax regimes. Furthermore, the arm's length principle is mixed up with the fair value standard (see Part I, 2.4.).

The present value of the free cash flow could be calculated using a discount rate estimated on the basis of the weighted average cost of capital for the specific business or intangible that is transferred. [205] However, the guidelines are open to the determination of the discount rate on another basis. [206] It is stated that a post-tax discount rate should be applied, and that the tax rate of the country where the business or intangible is located, should be applied. [207]

A tax amortization benefit should be added to the discounted cash value of an intangible. For this purpose it is recommended that only the tax regime of the country where the business is located be considered. [208] Hence, if an intangible is sold from Denmark to Germany, the Danish tax regime should apparently be applied to determine the tax

amortization benefit even though the intangible will be employed by a German company.

The guidelines recommend that a sensitivity analysis be made of one or several key input parameters. [209] At the same time it is recommended that an arm's length point be determined, rather than an arm's length range. [210]

6.4. OECD Guidelines

The OECD Guidelines contain four references to income-based methods. First, it is stated that a discounted cash flow analysis may be performed as part of the residual profit split method, or as a method in its own right. [211] It is stated that this approach may be effective in relation to start-up businesses, but no detailed guidance is provided. It is also noted that a discount rate should reflect the risks associated with the actual transaction, and that the relative timing of receipts can be problematic. On this basis it is held that the application of a discounted cash flow analysis would require considerable caution and should be supplemented, where possible, by information derived from other methods.

Second, there is a reference to the incremental income method, as it is stated that sales of unbranded products may be used as comparable transactions to sales of branded products that are otherwise comparable. [212] In such a case it is stated that the premium attributable to the brand might be determined by comparing the volume of sales, the prices chargeable and the profits realized from the branded products and the unbranded products.

Third, it is stated that in applying the arm's length principle to intangibles, some special factors relevant to comparability should be considered. [213] One such factor is the expected benefits from the intangible possibly determined by a present value calculation.

Fourth, it is stated that valuation methods used in acquisition deals between independent parties, may prove useful to valuing the transfer of an ongoing concern between associated enterprises. [214] In an example comparing the expected future income of a distributor under a high-risk alternative and a low-risk alternative, the OECD Guidelines in essence are relying on an income-based approach. [215]

To summarize, the OECD acknowledges the application of income-based methods, but adopts a cautious attitude and provides no real guidelines on the application of such methods. This may perhaps be explained by concern on the part of the tax authorities because the key input parameter is the expected future income – which leaves the methods open to manipulation by taxpayers. The absence of international rules creates uncertainty about appropriate approaches which is reflected in the diverging rules laid down in domestic tax laws. If the OECD should maintain its role as the international coordinator in the transfer pricing area, the organization should draw up rules on income-based methods. The transfer of intangibles is thus a key area of concern for the tax authorities, and the specified methods in the OECD Guidelines often cannot be reliably applied.

6.5. Comparative analysis and discussion

The following is a comparative analysis of some of the critical aspects of income-based methods under the domestic tax laws of the United States, Germany and Denmark, and a discussion of the application of such methods under Art. 9(1) of the OECD Model.

6.5.1. Scope of income-based methods

Under US tax law, the use of the income method is confined to situations where the transferee does not exploit the subject intangible together with its own non-routine resources. This is because of the difficulties in identifying uncontrolled taxpayers with the comparable, non-routine resources. Under German tax law, the use of an income-based method is mandatory where there are no unlimited or limited comparable transactions. This is also the case where other non-routine resources of the transferee will be employed together with the subject intangible. In such situations, enhanced profits will normally be caused by both the subject intangible and the other non-routine resources. It will thus be necessary to bifurcate the total intangible profits in order to identify the profits associated with the subject intangible. The German law, regulations and Draft Circular do not provide any guidance regarding this critical issue. Under US tax law, a residual profit split analysis on its own or in conjunction with an income-based method would normally qualify as the best method in such situations, causing the total intangible profits and economies of integration to be shared by the associated enterprises. [216]

The German approach means that profits that stem from synergies between the subject intangible and other non-routine resources may be assigned in a disproportionate manner to the subject intangible, i.e. to the transferor. This may be illustrated by an example where a transferor has incurred historical costs of 100 to develop a non-routine intangible. The present value of the profit potential of application *A* of the intangible is 1,000 for both the transferor and transferee. The transferee has developed nine other non-routine intangibles which solely will be exploited together with the subject intangible for the purpose of application *B* with a present value of the profit potential of 3,000 excluding historical intangible development costs of 900. In this example German tax law may entail that the transfer price for the subject intangible is determined to be 2,500. Hence, the profit potential for the transferor is 1,000. The profit potential for the transferee will be 4,000, i.e. 1,000 for application *A* and 3,000 for application *B*. The arm's length range is thus 1,000-

4,000 and the mid-value is 2,500. This will cause 1,500 (2,500 minus 1,000) or 50% of the profit potential of application *B* to be attributed to the subject intangible even though this application is based on ten non-routine intangibles. Under US tax law, an analysis under the comparable profits method of application *A* may result in an arm's length price of 1,000, whereas a residual profit split analysis of application *B* based on the capitalized and amortized intangible development costs may entail that 300 or 10% of the profit potential of application *B* is attributed to the subject intangible. The total transfer price under US tax law will thus be 1,300. Hence, under German tax law and US tax law, identical facts may lead to the application of different methods, resulting in widely differing results and increasing the risk of double taxation. [217]

The above considerations should guide the application of income-based methods from the perspective of Art. 9(1) of the OECD Model. In particular, where the subject intangible will be used together with other non-routine contributions, it may be necessary to supplement an income-based method with some kind of a residual profit split analysis.

6.5.2. Methodology

Under US tax law, the income method of the cost sharing regulations resembles an incremental income method. Under German and Danish tax law, the use of a variety of income-based methods is permitted, including the excess earnings method, the incremental income method and the relief-from-royalty method.

From the perspective of Art. 9(1) of the OECD Model, none of the income-based methods can per se be characterized as unreliable. A criterion to consider is whether the realistic alternative underlying a method is comparable to the controlled transaction. With regard to a transfer of the right to use an intangible, the profit potential considered should reflect the terms of the licence in question. On the other hand, if the aim is to evaluate the transfer of the ownership of an intangible, the arm's length test should consider all sources of profits associated with the intangible (see Part I, 1.). In this context, the relief-from-royalty method stands out because it determines the transfer price for the ownership of an intangible by reference to the arm's length price for the right to use the intangible. Hence, a key assumption underlying the method is that the value of ownership is identical to the value of the right to use an intangible. The method may be criticized for not necessarily capturing the full economic value of legal ownership of an intangible because a licence normally only transfers part of the rights of ownership. [218] This was the reason why the US Court of Appeals for the Second Circuit rejected the method in *Nestlé Holdings, Inc. v. Commissioner*. [219] The case concerned a US subsidiary which had transferred the ownership of intangibles to a Swiss parent company for USD 425 million, while the IRS determined the value to be USD 163 million. At trial, the IRS determined the value at USD 146 million under the relief-from-royalty method. The application of this method was recognized by the Tax Court but was rejected by the Court of Appeals:

In our view, the relief-from-royalty method necessarily undervalues trademarks. The fair market value of a trademark is the price a willing purchaser would have paid a willing seller to buy the mark. ... ("The willing buyer-willing seller test of fair market value is nearly as old as the federal income, estate, and gifts taxes themselves"). The relief-from-royalty model does not accurately estimate the value to a purchaser of a trademark. Royalty models are generally employed to estimate an infringer's profit from its misuse of a patent or trademark. Resort to a royalty model may seem appropriate in such cases because it estimates fairly the cost of using a trademark ... However, use of a royalty model in the case of a sale is not appropriate because it is the fair market value of a trademark, not the cost of its use, that is at issue. A relief-from-royalty model fails to capture the value of all of the rights of ownership, such as the power to determine when and where a mark may be used, or moving a mark into or out of product lines. It does not even capture the economic benefit in excess of royalty payments that a licensee generally derives from using a mark. Ownership of a mark is more valuable than a license because ownership carries with it the power and incentive both to put the mark to its most valued use and to increase its value. A licensee cannot put the mark to uses beyond the temporal or other limitations of a license and has no reason to take steps to increase the value of a mark where the increased value will be realized by the owner. The Commissioner's view, therefore, fundamentally misunderstands the nature of trademarks and the reasons why the law provides for exclusive rights of ownership in a mark. Given the shortcomings of the relief-from-royalty methodology, the Tax Court erred when it adopted the Commissioner's trademark valuations. The Tax Court is instructed to examine alternate methods of determining the fair market value of the trademark in question.

It must be assumed that the decision will curb the use by the IRS of the relief-from-royalty method to determine the transfer price of the ownership of an intangible. Hence, the IRS has referred to the reasoning of the Court without criticizing the outcome. [220] In fact, the outcome is held to be consistent with the position of the IRS on the distinction between make/sell rights and platform rights. [221] The method also requires information on the arm's length royalty rate for the subject intangible, and this will often not be available for non-routine intangibles. Depending on the facts of the individual case, the relief-from-royalty method may thus produce results that are less reliable than other income-based methods.

The income method laid down in the US cost sharing regulations essentially suffers from the same shortcoming, as it evaluates the arm's length price of the ownership of an intangible by reference to the market price for the right to use

similar intangibles (see 6.1.2.).

6.5.3. Perspective of the arm's length test

A key distinction between the domestic law approaches is the choice of perspective. Under US and Danish tax law, the income method is applied on a one-sided basis, with US tax law using the transferee as tested party, and Danish tax law assuming that the outcome will be identical regardless of whether the tested party is the transferor or the transferee. On the other hand, under German tax law, income-based methods should be applied on a two-sided basis. [222] The divergence does not arise as a result of the application of different methods, as both the excess earnings method and the incremental income method may be used on a one-sided or two-sided basis.

This difference between US and German law may be illustrated by an example where the present value of the profit potential of an intangible is 500 for the transferor and 900 for the transferee. The transfer price in this example will be 900 under US tax law and 700 under German tax law based on the presumption for the mid-point of the arm's length range $(500 + (900 \div 500/2))$.

In relation to Art. 9(1) of the OECD Model, an income-based method should adopt a dual perspective in order to comply with the arm's length principle. [223] This is already emphasized by the OECD. [224] However, this does not necessarily answer the question of whether the arm's length test should be made on a one-sided or two-sided basis. Where the profit potentials of both parties are identical, the two approaches will normally lead to similar results. On the other hand, where synergies, location savings etc. causes the profit potentials to differ, the use of a one-sided approach may lead to an income distortion vis-à-vis the arm's length principle.

6.5.4. Input parameters

The key input parameter under income-based methods is the projected profits. Among other things, the delimitation of the relevant income stream gives rise to the following issues:

- the identification of the income sources for the subject intangible;
- the determination of the useful life of the intangible;
- the income projection for the goods and services that incorporate the intangible;
- the identification of the intangible profits from the income projections;
- in the case of in-process R&D, a bifurcation of the projected income between R&D performed before and after the controlled transaction in question;
- the choice between an income or cash flow approach; and
- the choice between a pre-tax or a post-tax approach.

6.5.4.1. Income sources

The sources of income for the subject intangible may include (1) existing applications that do not require further development (make/sell value), (2) new applications based on maintenance development, known technical feasible development or unknown development (platform value) [225] and (3) subsequent transfers of the ownership or the right to use the intangible as well as new generations thereof incorporating the intangible.

The domestic tax laws of the United States, Germany and Denmark entail that the business judgment of taxpayers regarding the income sources of an intangible should, as a starting point, be recognized. The profit potential associated with exploiting an intangible as a platform for the development of new generations of the intangible should, in principle, be considered under income-based methods. However, no detailed guidelines exist on this critical issue which makes income-based methods highly vulnerable to international disputes.

This issue was addressed by the US Tax Court in *Veritas Software Corp. v. Commissioner*, which was decided on the basis of the 1995 cost sharing regulations. [226] This case concerned a US parent company that entered into a cost sharing arrangement with a newly incorporated Irish subsidiary, to develop and manufacture storage management software products. Pursuant to the cost sharing arrangement, the parent company granted the subsidiary the right to use certain existing intangibles in Europe, the Middle East, Africa and Asia. During 1999 and 2000, the subsidiary made buy-in payments of approx. USD 172 million. In 2002, the parties agreed to reduce this amount to USD 118 million. The parent company employed the comparable uncontrolled transaction method to calculate the buy-in payment. In 2006, the IRS issued a notice of deficiency to the parent company based on a buy-in payment of USD 2.5 billion, calculated by using the income method, the market capitalization method and an analysis of the parent company's acquisitions. During pre-trial proceedings the IRS abandoned its original analysis and submitted a new analysis that reduced the buy-in to USD 1.675 billion. The new analysis valued the aggregate of alleged intangibles, and was based on an income method using a perpetual life.

The Court rejected the argument of the IRS that the distinction between make/sell rights and platform rights had any bearing on the case under the 1995 cost sharing regulations:

Once again, respondent's contention is misguided. Respondent is relying on rights involving subsequently developed intangibles to support his assertion that the OEM agreements are not comparable to the controlled transaction. As previously determined herein, pursuant to section 1.482-7(g)(2), Income Tax Regs., the requisite buy-in payment need not take into account subsequently developed intangibles. With respect to the controlled transaction involving the transfer of preexisting intangibles and the uncontrolled transactions involving VERITAS US' unbundled OEM agreements, there are no significant differences in property or services provided.

It is surprising that the Court did not elaborate further on this issue, and that it rejected the position of the IRS by reference to the future cost-shared intangibles. Hence, under an income-based method, the value of existing intangibles contributed to a cost sharing arrangement is by definition determined on the basis of the projected income stream of the cost-shared intangibles. The Court also ruled that the IRS applied the wrong useful life of the existing intangibles, as, on average, the software had a useful life of four years. Further, based on the evidence, the Court noted that unrelated parties which license static technology that is neither subject to updates nor rights to new versions agree to ramp down the royalty rate over the life of the agreements:

Consistent with VERITAS US' other agreements involving static technology, the royalty rates for VERITAS US' preexisting product intangibles must be ramped down, starting in year 2, at a rate of 33 percent per year from the then-current percentage (i.e., 32 percent in year 1; 21 percent in year 2; 14 percent in year 3; and 10 percent in year 4). The Court thus acknowledged a definite useful life of the existing intangibles and the application of the declining-royalty method. However, this should be seen in the light of the fact that the Court confined the scope of the valuation to the make/sell rights.

Under the arm's length principle of Art. 9(1) of the OECD Model, the business judgment of a taxpayer on the income sources of an intangible must normally be accepted. For example, the strategy of an enterprise may entail that it will not enter a particular market segment even though this could be profitable in the short run. The tax authorities are thus not authorized to evaluate the expediency of legitimate business decisions. [227] The reliance on the business judgment of taxpayers creates a significant informational asymmetry that may be exploited by a dishonest taxpayer. [228] Under Art. 9(1), platform rights should also be considered.

6.5.4.2. Useful life

Under German tax law, a presumption for an indefinite useful life is laid down. Under US tax law, the useful life of an intangible should be determined on the basis of the actual circumstance considering its capacity as platform for the development of new generations of the intangible (see 6.5.4.1.). The same would apply under Art. 9(1) of the OECD Model. Relevant circumstances that may be taken into account in estimating the useful life include legal, technological, functional and economic factors. [229]

An indefinite capitalization period may be applied in corporate finance to establish the fair value of a corporation. In contrast, it would normally not be appropriate to assign an indefinite useful life to an intangible under the arm's length principle. The issue was touched upon in the Swedish *Ferring* case where a Swedish subsidiary transferred the legal title to all of its valuable intangible rights relating to certain pharmaceutical products to an associated enterprise in Switzerland for a transfer price of SEK 275.5 million. [230] Simultaneously, the two enterprises entered into an arrangement under which the Swedish subsidiary was engaged by the Swiss enterprise to perform contract manufacturing on a cost-plus 7.5% basis. The Swedish tax authorities determined that the transfer price for the intangibles was understated and made an adjustment of SEK 682 million. An expert witness of the taxpayer applied an indefinite capitalization period with regard to a controlled transaction that involved the transfer of specific intangibles. This approach was adopted because the transaction was held to cover not only the specific intangibles but also a business that was able to develop new products. On this basis, the expert witness had made a valuation of the share capital of the Swedish subsidiary before and after the transaction. In this regard, the expert witness missed the point that new products would be developed by the transferor and not the transferee. The tax authorities argued for a useful life of 10 years. The Court did not address the issue but ruled in favour of the taxpayer.

6.5.4.3. Income projections

The income stream underlying an income-based method should be determined on an ex ante basis. This causes an informational asymmetry, as the tax authorities usually do not possess detailed knowledge about the intangible in question or the business affairs of the taxpayer. It may thus be difficult for the tax authorities to evaluate the reliability of income projections prepared by taxpayers. Nevertheless, the income projections of taxpayers should normally be relied upon under the tax laws of the United States and Germany. This principle was also endorsed in the Swedish *Ferring* case (see 6.5.4.2.). While the ex ante principle is firmly embodied in the arm's length principle, as a practical matter, tax authorities can be expected to use actual profits to challenge the reasonableness of the assumptions underlying valuations prepared by taxpayers. [231]

Burden of proof issues are outside the scope of the arm's length principle of Art. 9(1) of the OECD Model. [232] Under US and German tax laws, a divergence between projected and actual income may be addressed by commensurate-with-income standards. The arm's length principle of Art. 9(1) does not incorporate a similar concept (see 7.5.).

6.5.4.4. Intangible profits

Income-based methods should be applied on the basis of the profits that stem from the subject intangible rather than other, existing or future, production factors. [233] For example, under the incremental income method, it is pivotal to avoid mixing intangible profits and routine profits (see 6.2.).

Where an income-based method is applied on a company wide basis, it may capture completely the full economic value of any and all existing and future intangibles of the transferee. [234] If the intangible in question will be employed together with other non-routine contributions, it may be necessary to supplement an income-based method with a residual profit split analysis (see 6.5.1.). In *Veritas Software Corp. v. Commissioner*, the US Tax Court held that the application of an income-based method by the IRS was unreasonable, among other things, because it took into account intangibles that were developed subsequently (see 6.5.4.1.).

Furthermore, enhanced income may be partly attributable to economies of integration such as synergies, large volumes, a market position etc. [235] Income from economies of integration should ideally be shared by the associated enterprises rather than being assigned to the subject intangible under Art. 9(1) of the OECD Model.

6.5.4.5. In-process R&D

The valuation of in-process R&D is addressed only by US tax law. [236] The income method of the cost sharing regulations is based on the axiom that the risks associated with future R&D (cost contributions) cannot be placed on a par with the risks associated with past R&D (non-routine platform contributions) (see 6.1.2.). [237] The underlying theory is that there is greater uncertainty at the beginning of the development process, and the initial investor should accordingly obtain a higher return. [238]

The position of the US cost sharing regulations will not always be consistent with the arm's length principle of Art. 9(1) of the OECD Model. [239] One problem is the basic assumption that the value of past R&D exceeds the value of future R&D. This assumption will, in particular, be problematic if the risks associated with the future research activity will be high, if the relative value of the platform contribution to the overall cost sharing arrangement activity will be low or if the cost share for the transferor will be minor. Another problem is the way that the difference in value, if any, is determined. Hence, under the US regulations, non-routine profits from the finished intangible are fully assigned to the participant that made the past R&D which means that the compensation for future R&D is determined on the basis of the licensee not bearing any R&D risk. [240] The fact that the income method allows the use of different discount rates for the cost sharing arrangement alternative and the licensing alternative, will normally not make up for the difference in results compared to an analysis under the residual profit split method. Moreover, the IRS has previously indicated that the comparable profits method would often not be applicable to platform contributions, as the transferee would be the owner of the cost-shared intangibles. [241]

6.5.4.6. Income or cash flow

Under US tax law, the input under the income method is either income or cash flow. Under German and Danish tax law, free cash flow should be used as the input. With regard to Art. 9(1) of the OECD Model, it will depend on the facts of the individual case whether the use of income or cash flow is likely to produce the most reliable arm's length result.

The importance of this issue is evidenced by the Swedish *Ferring* case where both the taxpayer and the tax authorities relied on the incremental income method (see 6.5.4.2.). The taxpayer applied the discounted cash flow method and made a full gross-up for taxes. On the other hand, the tax authorities used the discounted earnings method. The Court recognized the taxpayer's use of the discounted cash flow method, because it did not contradict the OECD Guidelines, and because the tax authorities had not substantiated that their method was more reliable. The Court accepted the taxpayer's argument that the use of income rather than cash flow caused a significant flaw in the valuation prepared by the tax authorities because it did not take into account that the conversion to a contract manufacturer meant that net working capital of SEK 388 million was expected to be at the disposal of the transferor.

6.5.4.7. Taxes

Under US tax law, the transfer price should be determined on a pre-tax basis. If post-tax income is used as input, the post-tax value must thus be grossed up to reflect the buy-in payment on a pre-tax basis. Under Danish tax law, an adjustment for a tax amortization benefit must be made, whereas this is presumably not required under German tax law. With regard to Art. 9(1) of the OECD Model, the transfer price should be determined on a pre-tax basis. This would be consistent with the general approach of transfer pricing to measure profits on a pre-tax basis because market prices are on a pre-tax basis. [242] With regard to the right to use an intangible, it has never been contested that a royalty should be determined on a pre-tax basis. So why should another approach be adopted just because the form of the transaction is changed to a transfer of ownership? Furthermore, a transfer pricing analysis should provide information on the price or

profit that a taxpayer could have realized under a realistic alternative, i.e. the opportunity cost. [243] Assuming that a taxpayer has the realistic alternative of exploiting an intangible rather than transferring it to an associated enterprise, the income from exploiting the intangible will normally be taxable. In order for the two alternatives to be comparable, the value determined under the income method must thus be on a pre-tax basis. All things else being equal, the arm's length price should be identical, regardless of whether the input parameter is pre-tax income or post-tax cash flow grossed up for taxes.

The difference in the treatment of taxes under income-based methods may be illustrated by an example where the present value of the profit potential (determined on the basis of earnings before interest, taxes, depreciation and amortization (EBITDA)) of an intangible is 1,000, and the applicable tax rate is 25% for both the transferor and transferee. Under alternative 1, the intangible is transferred, whereas under alternative 2, no transaction takes place and the intangible is exploited by the owner. It is assumed that the transferor will be subject to tax on the transfer price of the intangible, and that the transferee will be entitled to amortize the transfer price of the intangible for tax purposes. For the sake of simplicity, no account is made for the timing difference between the recognition of the capital gain and the amortization of the purchase price. On this basis the effect of making a full tax gross-up, a partial tax gross-up or no tax gross-up may be illustrated as follows:

	Full tax gross-up	Partial tax gross-up	No tax gross-up
<i>Transferee</i>			
Alternative 1: Buying the intangible			
present value of EBITDA	1,000	1,000	1,000
hypo tax, 25% of EBITDA	(250)	(250)	(250)
present value of post-tax income	750	750	750
full tax gross-up, 25%	250	–	–
partial tax gross-up, e.g. 25% of post-tax income	–	187.5	–
transfer price of intangible	1,000	937.5	750
gain/loss, post-tax:			
EBITDA	1,000	1,000	1,000
amortizable transfer price	(1,000)	(937.5)	(750)
gain/(loss), pre-tax	0	62.5	250

	tax, 25%	0	(15.6)	(62.5)
	gain/(loss), post-tax	0	46.9	187.5
<i>Transferor</i>				
Alternative 1: Selling the intangible				
	capital gain (from transferee, Alternative 1)	1,000	937.5	750
	tax, 25% of capital gain	(250)	(234.4)	(187.5)
	present value of post-tax income	750	703.1	562.5
Alternative 2: Exploiting the intangible				
	present value of EBITDA	1,000	1,000	1,000
	tax, 25% of EBITDA	(250)	(250)	(250)
	present value of post-tax income	750	750	750
gain/(loss), post-tax:				
	present value of Alternative 1	750	703.1	562.5
	present value of Alternative 2	(750)	(750)	(750)
	gain/(loss), post tax	0	(46.9)	(187.5)

The example shows that a calculation of the transfer price on a post-tax basis with a full gross-up for taxes means that the present value of the two alternatives, with and without the intangible, for both parties will be identical. This approach does not entail that the transferee will be paying the taxes for the transferor, as the transferee is assumed to be entitled to claim a tax deduction equal to the grossed up transfer price. The EBITDA will thus be fully set off by the transfer price for the intangible, and the taxes will be eliminated. This means that the transfer price in the example will be identical regardless of whether the tax rate is 25%, nil, or any other rate. In contrast, if the transfer price is calculated on a post-tax basis without a full gross-up for taxes, the transferor will be worse off selling the intangible and the transferee will realize income in excess of the cost of capital of buying the intangible. The example does not take into account the effect of a timing difference between taxation and amortization. Likewise, economic double taxation that may arise if an item of income is taxable in one country and the related expenditure is a non-deductible item in the other country is not considered. Such issues are of a general nature and apply to all types of controlled transactions.

6.5.5. Other issues

Other issues that should be considered under income-based methods include:

- whether to make a transactional or aggregated arm's length test;
- the determination of an appropriate discount rate; and
- the use of arm's length ranges.

6.5.5.1. Transactional or aggregated test

If multiple intangibles are transferred between associated enterprises, it should be determined whether to make the arm's length test on a transactional or an aggregated basis. Under US, German and Danish tax law, the evaluation should, as a starting point, be made on a transactional basis. An aggregation of multiple controlled transactions should be made if this would enhance the reliability of the results. However, German tax law provides for a mandatory aggregation of transactions in the case of a relocation of functions subject to certain exceptions. Under Art. 9(1) of the OECD Model, an aggregation should only be made if this will provide a more reliable arm's length result based on the facts of the individual case. [244] For example, this may be appropriate where the synergy or integration between the intangibles is such that neither element can be valued separately from the other. [245] In the Swedish *Ferring* case, an expert witness of the taxpayer made an aggregated valuation of all the intangibles covered by a controlled transaction which included finished intangibles and in-process R&D (see 6.5.4.2.). The tax authorities argued that there was no interaction between these two categories of intangibles and that separate arm's length tests should thus be performed under the OECD Guidelines. The Court did not specifically address this issue.

In *Veritas Software Corp. v. Commissioner*, the IRS had made an aggregated valuation of intangibles because the assets "collectively possess synergies that imbue the whole with greater value than each asset standing alone" (see 6.5.4.1.). However, the IRS expert testified that he did not have an opinion as to whether his methodology captured the synergistic value of the transferred intangibles. The US Tax Court decided that the aggregated valuation did not provide the most reliable arm's length result under the 1995 regulations because it caused short-lived intangibles to be valued as if they had a perpetual life and took into account intangibles that were developed subsequently rather than existing. Hence, the criticism of the Court was primarily directed at the application of the income method and the determination of the useful life rather than the aggregation approach as such.

6.5.5.2. Discount rate

The determination of appropriate discount rates will be of increased importance in transfer pricing as tax authorities are turning to income-based methods. Under the domestic tax laws of the United States, Germany and Denmark as well as Art. 9(1) of the OECD Model, the present value of the projected income should be calculated on the basis of an appropriate risk-weighted discount rate. Determining an appropriate discount rate is crucial, as the discount rate incorporates the risk element of the controlled transaction. The discount rate may vary between the alternatives being compared.

Discount rates are generally used on a post-tax basis because interest expenses are deductible. [246] As discount rates estimated on the basis of capital market data are normally post-tax discount rates, one approach is to use post-tax discount rates to post-tax income and then make a gross-up for taxes. Another approach would be to use post-tax discount rates to pre-tax income.

In *Veritas Software Corp. v. Commissioner*, the IRS had determined the discount rate for a buy-in payment on the basis of a weighted average cost of capital derived under the capital asset pricing model (see 6.5.4.1.). The US Tax Court found several errors in the determination of the discount rate. First, the discount rate was calculated on the basis of an industry-average beta of 1.42 rather than a company-specific beta of 1.935. This caused distortions because of the inclusion and size of Microsoft in the industry average. Hence, Microsoft had a stronger and more established business than Veritas, and thus the risk level for Veritas' industry did not present a portfolio of comparable risk. Second, the equity risk premium had been determined at 5%, which was much lower than the 1926 to 1999 historic average of 8.1%. The Court rejected the explanation given by the IRS expert that the long-term yield for the US market was higher than the long-term yield for foreign markets. Third, the risk-free interest rate had been determined on the basis of the 20-year US Treasury bond yield rather than the classic formulation of the capital asset pricing model (CAPM) based on the 30-day US Treasury bill rate. The IRS expert acknowledged that he had used the wrong risk-free rate because account had not been taken of the risk premium of Treasury bonds over bills. On this basis the 13.7% discount rate of the IRS was replaced with the 20.47% applied by the taxpayer.

6.5.5.3. Arm's length ranges

Both US and German tax law require that an arm's length range be created. Under US tax law, the range is determined on the basis of the variable input parameters. On the other hand, under German tax law, the range is determined on the basis of the profit potentials of the parties. The arm's length ranges of US and German tax law are thus addressing different issues. Under Art. 9(1) of the OECD Model, it would be appropriate to consider both aspects.

6.6. Summary

The above analysis of the domestic tax laws of the United States, Germany and Denmark reveals that there is no international consensus on the scope, methodology, input parameters or certain other issues relating to the application of income-based methods. The application of income-based methods on the basis of identical facts may thus lead to widely different results in the three countries. This gives rise to uncertainty and risk of double taxation.

7. Alternative Non-Arm's Length Rules

7.1. General

The difficulties and uncertainties associated with making arm's length tests of intangibles have caused countries to adopt a variety of alternative non-arm's length measures to supplement the arm's length principle. The rules may be categorized as specific transfer pricing measures and general tax measures. While some of the rules do not interfere with the arm's length principle, others are in breach of this principle. Tax treaty provisions corresponding to Art. 9(1) of the OECD Model may prevent the application of the latter type of rules. The question of whether domestic tax rules that override tax treaty provisions take precedence over tax treaties, relies on the general relationship between domestic tax law and tax treaties in the particular country.

A brief discussion is presented below of certain common non-arm's length measures that countries may adopt in order to supplement the arm's length principle. The discussion is confined to measures that may be effective in relation to controlled transactions with associated enterprises resident in tax treaty countries. Hence, the general pattern of multinational enterprises is to transfer intangibles to companies in jurisdictions within the international treaty network. A consideration of tax measures such as general anti-avoidance rules and rules that are aimed at transactions with entities in low-tax jurisdictions outside the tax treaty network, is beyond the scope of this article. [247]

7.2. Documentation and reporting

A common measure consists of transfer pricing documentation requirements that address the issue of informational asymmetry. Documentation rules are normally designed to deal with the transfer of goods and services rather than the transfer of intangibles. It would thus be appropriate to establish special documentation requirements addressing the input parameters and other particular issues associated with the application of income-based methods (see 6.5.4. and 6.5.5.). The rules may be graded depending, for example, on the size of the enterprises and the countries involved. [248] In 2009, the Danish tax authorities published guidance on the proper documentation in relation to the transfer of intangibles. [249] Moreover, the International Valuation Standards Council has issued guidelines on valuation reports. [250]

The time frame for the preparation of transfer pricing documentation may be moved forward in the case of a transfer of valuable intangibles. For example, German law requires that the documentation be prepared contemporaneously with regard to extraordinary transactions such as the relocation of functions or the transfer of intangibles. [251]

Tax return reporting requirements may be imposed in order to make tax authorities aware of extraordinary transactions that may have been undertaken for tax planning purposes, such as the transfer of intangibles. Under Danish tax law taxpayers are generally required to provide tax return information regarding the nature and amount of controlled transactions. [252]

7.3. Burden of proof

The burden of proof in transfer pricing cases rests with the tax authorities in many jurisdictions. This will often be a heavy burden because the key input parameter under income-based methods is income projections. It may be difficult for the tax authorities to substantiate that income projections were unreliable on an ex ante basis. This issue may be dealt with in various ways.

The burden of proof in cases dealing with intangibles may generally be shifted to taxpayers. The effect of reversing the burden of proof depends on the particularities of each jurisdiction. For example, the fact that the burden of proof rests with taxpayers in the United States is far from clear, considering the litigation track record of the IRS.

A less burdensome measure would be to confine a reversal of the burden of proof to situations where a taxpayer does not comply with the documentation requirements. For example, under Danish [253] and German [254] tax law, the tax authorities are authorized to determine transfer prices on an estimated basis if a taxpayer has not complied with the documentation requirements.

Another approach would be to provide that, at a certain time after a transfer of an intangible, a test could be made of whether the critical assumptions for the valuation have been satisfied. [255] If, to a significant degree, the critical assumptions have not been satisfied, the burden of proof that the arm's length principle was complied with at the time of the transaction could be shifted to the taxpayer. On this basis, taxpayers would retain the right to provide evidence that the failure of a critical assumption was not predictable at the time of the transaction.

A more specific measure is to use statutory presumptions to the benefit of the tax authorities. For example, under the Norwegian transfer pricing provision, if an associated enterprise is resident in a country outside of the EEA and there is

reason to believe that income has been shifted to the associated enterprise, such income shifting will be deemed to have resulted from the common control, unless the taxpayer can document that such is not the case. [256] Likewise, the French transfer pricing provision provides that when income shifting is made to the benefit of a company resident in a low-tax jurisdiction, the tax authorities are not required to prove the interdependence between the companies. [257] Under German law, there is a rebuttable presumption that an indefinite capitalization period should be applied, [258] and that the arm's length price corresponds to the mid-point of the arm's length range where a hypothetical arm's length test is performed. [259] Under US tax law, the cost sharing regulations incorporate rebuttable presumptions relating to the realistic alternatives of the parties and the investor model (see 6.1.2.).

Art. 9(1) of the OECD Model does not address the burden of proof in transfer pricing cases. Furthermore, tax treaties may not normally tighten up taxation under domestic tax law. Hence, a burden-of-proof rule should be adopted in domestic law. However, this should not prevent the OECD from drafting a special burden-of-proof rule regarding the transfer of intangibles which may form the basis for domestic rules. Such an approach would ensure international consensus. The question of whether there is a need for amending the burden-of-proof rules must be answered on the basis of the state of the law in each jurisdiction.

7.4. Realistic alternatives

Under income-based methods, the arm's length test of the transfer of intangibles is generally made on the basis of the realistic alternatives of the parties. Realistic alternatives to a controlled transaction may be applied in two fundamentally different capacities in a transfer pricing analysis, namely:

- as a criterion under the comparability analysis of the arm's length principle; and
- as a separate means for determining transfer prices.

The US Sec. 482 regulations from 1994 make use of realistic alternatives both for the purpose of evaluating the comparability requirement [260] and as a separate means for evaluating transfer prices. [261] In the latter capacity the rules may trigger an adjustment, even though the result of a controlled transaction corresponds to the result of a comparable uncontrolled transaction. [262] The regulations provide that an unspecified method should provide information on the prices or profits that the controlled taxpayer could have realized by choosing a realistic alternative to the controlled transaction. [263] The use of realistic alternatives as a separate means for establishing arm's length prices is illustrated by examples which show, among other things, that the arm's length test of a royalty rate may take into account the result of the taxpayer's alternative of producing and selling the goods itself. [264] If the alternative transaction would be expected to provide the taxpayer with higher profits than the actual transaction, the transfer price of the actual transaction is considered not to be arm's length. The examples confirm that the valuation of intangibles under the regulations is viewed from the perspective of the transferor. As intangibles are usually transferred from US parent companies to foreign subsidiaries, the regulations safeguard the US tax base.

The rules on realistic alternatives were developed by the IRS as response to the outcome of *Bausch & Lomb, Inc. v. Commissioner*, in which the US Tax Court concluded that the arm's length principle under the 1968 regulations did not provide authority for disregarding the actual transaction because of the existence of a realistic alternative that was considered by the IRS to be more expedient from a business perspective. [265] The judgment was confirmed by the Court of Appeals. The US courts have not yet had an opportunity to determine whether the 1994 regulations on realistic alternatives conform with Sec. 482. [266]

The US fiscal year 2011 budget proposals would add to Sec. 482 a realistic alternative approach for intangibles, which is intended to receive a similar result as the highest and best use principle of the fair value standard (see Part I, 2.4.). [267]

The OECD Guidelines emphasize that the valuation of intangibles should not be made on the basis of a highest and best use principle (see Part I, 2.4.). [268] The OECD has previously stated that it would be inappropriate to use realistic alternatives as a separate means for establishing arm's length prices under Art. 9(1) of the OECD Model. [269] Hence, this use of realistic alternatives may generally be in breach of the following principles: (1) the controlled transaction should be recognized as actually structured, (2) the arm's length test should be made from the perspectives of both parties [270] and (3) the profit maximization ideal of the arm's length principle should be considered, both in relation to the overall business of the taxpayer and to the overall business strategy of the taxpayer. [271] For this reason, it is disturbing that the 2010 OECD Guidelines state that realistic alternatives are relevant to both the comparability and the pricing of a transaction. [272] It is unclear whether the discussion draft is attempting to diverge from the previous position of the OECD.

Income-based methods rely on the realistic alternative of the parties (see Part I, 4.). In order for the use of an income-based method to satisfy the arm's length principle of Art. 9(1), it should be ensured that the realistic alternatives are comparable to the controlled transaction, that a dual perspective is applied and that the realistic alternatives are sensitive to the business judgment and strategy of the taxpayer.

7.5. Commensurate-with-income standard

The arm's length principle must generally be applied on an ex ante basis. A commensurate-with-income standard entails that the transfer price is evaluated on an ex post basis, i.e. projected profits are replaced with actual profits of the transferee realized subsequent to the transaction. A commensurate-with-income standard must thus be coupled with rules on periodic adjustments.

In 1986, the United States enacted a commensurate-with-income standard to address the uncertainty associated with the arm's length test of intangibles and the informational asymmetry between taxpayer and tax authorities in such cases. [273] This was made in response to court decisions concluding that the traditional arm's length principle under the 1968 regulations did not allow the IRS to evaluate transfer prices on the basis of ex post information. [274] In 1998, Canada enacted a rule that authorizes the tax authorities to recharacterize a controlled transaction in accordance with the OECD Guidelines. [275] The recharacterization rule accommodates the application of a commensurate-with-income standard. [276] In 2007, Germany followed suit and enacted a commensurate-with-income standard. [277] In 2010, the UK tax authorities outlined a proposal for a commensurate-with-income standard that would impose an additional tax charge in limited circumstances for a finite period where the transfer price of an intangible at the date of transaction is difficult to calculate and the value has significantly increased following the transfer from the United Kingdom. [278] The contents of the commensurate-with-income standards of US and German tax laws are very different. [279]

The OECD Guidelines state that the arm's length principle means that the form of payment for intangibles should conform to market terms when the valuation is highly uncertain at the time of the transaction. [280] On this basis the OECD Guidelines essentially construe the arm's length principle of Art. 9(1) of the OECD Model as incorporating a commensurate-with-income standard. However, an adjustment of the form of payment would be in breach of the principle of the recognition of the controlled transaction as actually structured. [281] Such a recharacterization is contrary to the traditional arm's length principle of Art. 9(1). This has been confirmed in the US cases cited above as well as in numerous other court cases across the world including the Swedish *Ferring* case (see 6.5.4.6.).

Several things suggest that the effect of a commensurate-with-income standard is limited. Hence, a report by the US tax authorities indicates that foreign related companies still realize a significant share of the return on intangibles owned by US multinational enterprises. [282] One of the issues associated with commensurate-with-income standards is that it may be impossible to identify and measure the return on an intangible reliably in the years following a controlled transaction in which it is transferred. In the meantime, the intangible may have been enhanced, formed the basis for the development of new intangibles, been subdivided into multiple rights, been sold in whole or in part, etc. Further, the transferee will exploit the transferred intangible together with other production factors, and this will necessitate a segmentation of the return from the intangible in question and the return from other production factors, which will often be an arbitrary exercise. In addition, a commensurate-with-income standard does not affect investments in new intangibles made by a foreign associated enterprise.

On the above basis, the OECD should refrain from adopting a commensurate-with-income standard to supplement the arm's length principle of Art. 9(1). Such a step would also require a renegotiation of most tax treaties, as well as an amendment of most domestic transfer pricing provisions.

7.6. The authorized OECD approach

A radical measure against tax planning involving intangibles would be to revoke the principle of the recognition of controlled transactions as actually structured. Hence, Art. 9(1) could be oriented towards the authorized OECD approach adopted in relation to Art. 7 of the OECD Model, under which assets and risks are allocated based on the functions performed. [283] On this basis, it would be impossible to make a contractual separation of assets/risks from the functions performed. [284] If an intangible is created and the risks managed by an enterprise resident in a high-tax country, the return on the intangible could not be allocated to an associated enterprise in a low-tax country even though it had legal title to the intangible and had assumed the risks contractually.

The authorized OECD approach has not formally been adopted under the domestic laws of any OECD country in relation to transfer pricing between associated enterprises. However, the principles underlying the authorized OECD approach have been endorsed by the tax authorities of the Netherlands, for example. [285] In an Art. 9(1) context, the authorized OECD approach cannot be recommended, because of the significant detriment to the rule of law. Substantial doubts about the income allocation of multinational enterprises would arise if it were based on a factual criterion rather than a legal criterion, and the allocation of assets and risks were to be significantly different than for other tax and legal purposes. Nevertheless, the OECD is attempting to adopt the authorized OECD approach in relation to Art. 9(1). [286]

7.7. Formulary apportionment

The conceptual and practical issues associated with the arm's length principle may generally be addressed by a paradigm shift to formulary apportionment. This would also cope with the issues relating to intangibles. In the United States, formulary apportionment is usually advocated as a mandatory measure aimed at preventing income shifting. On

the other hand, in the European Union, formulary apportionment is seen as a non-mandatory measure to mitigate the tax compliance burdens of taxpayers. [287] Realistically, it must be assumed that the arm's length principle will prevail as a cornerstone of international tax law for the foreseeable future. All the OECD Member countries thus rely on the arm's length principle in their domestic tax laws, and there is no sign of a desire for a paradigm shift. This would in any case be complicated, as the arm's length principle is the allocation norm in the network of international tax treaties. According to the Committee on Fiscal Affairs, in spite of its shortcomings, the arm's length principle is the allocation norm that is most suitable for ensuring a fair income allocation and preventing double taxation. [288] The arm's length principle is also based on core values of tax law, such as the principles of equality and neutrality. The ongoing support for the arm's length principle has been evidenced most recently in the new interpretation of Art. 7 of the OECD Model, under which the application of the arm's length principle has been consolidated and the opportunity to use formulary apportionment has been revoked. [289] Further, a recent report by the Joint Committee on Taxation of the US Congress refers to the possibility of replacing the arm's length principle by formulary apportionment only in a footnote, and points out that, among other things, this could lead to the outsourcing of routine activities abroad. [290]

7.8. CFC taxation

The use of CFC rules to address the difficulties of applying the arm's length principle has recently been considered by the tax authorities of various countries. In 2007, the Danish tax authorities proposed that the definition of CFC income be expanded to include revenue from the sale of goods manufactured on the basis of patents. [291] The aim of this proposal was to target principal companies where intangible profits are incorporated in trading income rather than royalty streams. The proposal was withdrawn following pressure from the industry.

In 2010, the tax authorities of the United Kingdom published a proposal for a new CFC regime. [292] The new rules would target the artificial diversion of UK profit rather than taxing profits that are genuinely earned in foreign subsidiaries. Business has argued that the transfer of intangibles from the United Kingdom to foreign subsidiaries should solely be addressed by "exit" taxation and transfer pricing rules. However, the tax authorities are of the view that it is necessary to supplement the transfer pricing rules with the CFC regime. Under this proposal, the test of an artificial diversion of profits from the United Kingdom would be based on the extent to which a foreign subsidiary that legally owns intangibles undertakes active intangible management similar to a trading activity. This substance test resembles the authorized OECD approach which the OECD has adopted in an Art. 7 context (see 7.2.5.).

In 2010, the US tax authorities also proposed to address the issue of migration of intangibles to low-tax jurisdictions by expanding the definition of subpart F income to include, in certain circumstances, "excess returns" from the transfer of intangibles by a US person to a related low-taxed CFC. [293]

An expansion of CFC regimes to address transfer pricing issues gives rise to discussion on the compatibility of such regimes with tax treaties and EU law. With regard to tax treaties, the OECD is of the view that CFC rules normally do not infringe on tax treaties. [294] The outcome of court cases addressing the issue has not been consistent. [295] In an EU context, the ECJ decision in the *Cadbury Schweppes* case indicates that traditional CFC regimes can be justified under the fundamental freedom rights of the Treaty on the Functioning of the European Union only if they are confined to wholly artificial arrangements intended to escape the national tax normally payable. [296] This test is not met if a CFC is actually established in its home country and carries on genuine economic activities there. On this basis, traditional CFC regimes will normally not be effective where the CFC is conducting an active trade in its home country. [297]

The use of CFC rules to address the transfer pricing of intangibles means that the residence country of the parent company will have to share the intangible profits with the residence country of the CFC, as a foreign tax credit is normally granted for income taxes paid by a CFC. Hence, the measure will normally not be as efficient as establishing an appropriate transfer price with regard to the transfer of intangibles to a CFC. However, CFC rules may capture profits of new intangibles developed by the CFC which would not be taxable under transfer pricing rules.

8. Conclusion

This article has examined the use of income-based methods to determine the arm's length price of an intangible. The arm's length test of intangibles involves great uncertainty because of the lack of empirical data on market prices for intangibles (the value of an intangible is normally its value in use) and informational asymmetry between taxpayers and the tax authorities.

Income-based methods address the issue of lack of empirical market data and the issue of the value of an intangible being its value in use. The new methods generally entail a shift from direct, empirical methods to indirect, hypothetical methods. The arm's length principle differs from the fair value standard applied in corporate finance and financial reporting. The outcome of valuations made under these standards will thus not necessarily coincide. It is thus crucial to clearly define the premise of a valuation. In addition, in transfer pricing a valuation is usually confined to a single intangible or group of intangibles, whereas in corporate finance valuation is often made on a group or entity level. Thus, in a transfer pricing context there is a need for a refinement of the income-based methods in order to reliably capture

more narrowly defined income streams of individual intangibles.

The new income-based methods of domestic tax laws are basically similar to the profit methods introduced in the mid-1990s. However, the calculation of a present value under the new methods adds an additional level of complexity to the arm's length test. The new rules laid down in the domestic tax laws of the United States, Germany and Denmark are inconsistent. Moreover, the domestic rules may cause income distortion vis-à-vis the arm's length principle of Art. 9(1) of the OECD Model. The rules are thus designed to prevent an erosion of the national tax bases. Another drawback of the rules is that they may be used to shift income from high-tax jurisdictions, where intangibles are owned by an enterprise resident in a low-tax jurisdiction. [298] The domestic rules thus contain the seed of the problem that they are intended to resolve. The OECD Guidelines provide no real guidance on the use of income-based methods in the context of the transfer of intangibles. However, the OECD has decided to launch a project on intangibles that may result in an international consensus on the application of income-based methods.

Income-based methods do not address the issue of informational asymmetry. Under the new income-based methods the key input parameter is projected profits rather than actual profits. This offers taxpayers the opportunity of tax manipulation. Income-based methods are thus not a panacea for transfer pricing of intangibles and will often only be capable of defining a range of arm's length values of an intangible.

From the perspective of the arm's length principle of Art. 9(1) of the OECD Model, the following main rules may be applied regarding the use of transfer pricing methods to evaluate the arm's length price of non-routine intangibles:

Method	Payment form		Contribution of transferee	
	Royalty	Lump sum	Routine	Non-routine
CUP / CUT	√	√	√	√
Comparable profits method / TNMM	√		√	
Residual profit split method	√			√
Income-based method		√	√	
Income-based method with a residual profit split		√		√

The alternative non-arm's length rules of a substantive nature are all in breach of the arm's length principle of Art. 9(1). Hence, rules that apply realistic alternatives on a one-sided basis as a separate means of establishing transfer prices (highest and best use principle), commensurate-with-income standards, the authorized OECD approach and formulary apportionment are inconsistent with Art. 9(1). Moreover, it is questionable whether it is necessary with such alternatives. Thus, the current need seems to be for the creation of internationally agreed substantive arm's length rules by the OECD which may be supplemented by formal and procedural rules under domestic law to address the informational asymmetry. CFC rules may function as a backstop on the migration of intangibles if other means turns out to be inefficient.

* © Jens Wittendorff, 2010. International Tax Partner, Deloitte Copenhagen, and Prof. Hon., Aarhus School of Business, Aarhus University. The author can be contacted at jwittendorff@deloitte.dk. The views expressed in this article are those of the author and do not necessarily reflect those of Deloitte.

122. See Preamble, Explanation of Provisions, Sec. 1.482-4T(f)(4), in TD 9278 (IRB 2006-34).

123. Treas. Reg. Sec. 1.482-4(c)(2)(iii)(B)(1)(ii).

124. Preamble, Explanation of Provisions, Sec. 1.482-4(c)(2)(iii)(B)(1), in TD 8552 (IRB 1994-31).
125. Para. 6.22 of the OECD Guidelines sets forth a similar argument.
126. Treas. Reg. Secs. 1.482-4T(g) and 1.482-9T(m)(3).
127. Treas. Reg. Sec. 1.482-7T(g)(4)(i)(D).
128. See Sec. IV.D., Coordinated Issue Paper, "Section 482 CSA Buy-In Adjustments", LMSB-04-0907-62 (27 September 2007).
129. Preamble, Explanation of Provisions, Sec. 1.482-7T(g)(4), in TD 9441 (IRB 2009-7).
130. Sec. IV.C., Coordinated Issue Paper, "Section 482 CSA Buy-In Adjustments", LMSB-04-0907-62 (27 September 2007); Industry Director Directive #2 on Cost Sharing Buy-In Payments, LMSB-4-0308-016, 21 March 2008.
131. Treas. Reg. Sec. 1.482-7T(g)(4)(i)(A) and (iv). See Sec. IV.C., Coordinated Issue Paper, "Section 482 CSA Buy-In Adjustments", LMSB-04-0907-62 (27 September 2007); "APA 2003 Study Guide" (Washington D.C.: IRS, 2003), at 30.
132. Treas. Reg. Sec. 1.482-7T(g)(4)(vi).
133. Similarly regarding the comparable profits method (see Part 1, 5.1.1.) and regarding the relief-from-royalty method (see 6.5.2.).
134. Treas. Reg. Sec. 1.482-7T(g)(4)(i)(B).
135. Treas. Reg. Sec. 1.482-7T(g)(4)(i)(C).
136. Treas. Reg. Sec. 1.482-7T(g)(4)(iii).
137. The transferor will usually be the tested party under the concept of realistic alternatives. See below.
138. Treas. Reg. Sec. 1.482-7T(g)(4)(iii)(A).
139. Treas. Reg. Sec. 1.482-7T(g)(4)(iii)(B).
140. Treas. Reg. Sec. 1.482-7T(g)(1) and (2).
141. Treas. Reg. Sec. 1.482-7T(g)(2)(iii)(A).
142. See E. King and C. Fanaroff, "The Case Against The Income Method", 126 *Tax Notes* (2010), at 363.
143. Sec. II.A., Coordinated Issue Paper, "Section 482 CSA Buy-In Adjustments", LMSB-04-0907-62 (27 September 2007); "APA 2003 Study Guide" (Washington D.C.: IRS, 2003), at 25.
144. Preamble, Explanation of Provisions, Sec. 1.482-7(g)(2)(iv), in REG-144615-02 (IRB 2005-40).
145. Treas. Reg. Sec. 1.482-7T(g)(4)(i).
146. K. Reams et al., "Proposed cost sharing regulations: Are they a realistic alternative?", 109 *Tax Notes* (2005), at 239.
147. Preamble, Explanation of Provisions, A. Overview, in REG-144615-02 (IRB 2005-40).
148. Treas. Reg. Sec. 1.482-7T(g)(2)(ii)(A).

149. R.T. Cole, "IRS Guidance on Cost-Sharing Buy-In Transactions: Creeping Toward Fairness", 50 *Tax Notes International* (2008), at 563.
150. Treas. Reg. Sec. 1.482-7T(g)(2)(vi).
151. This is in line with court cases dealing with other areas of US taxation, where the IRS has only limited scope for substituting its judgment for a taxpayer's business judgment. For example, in relation to Sec. 531, see *Thompson Eng'g Co. v. Commissioner*, 751 F.2d 191 (6th Cir. 1985) ("The determination of reasonable needs of its business is, in the first place, a task for the officers and directors of a corporation ... IRC Section 531 does not empower the tax court to substitute its judgment for the corporation's officers concerning whether corporate dividends should be declared".).
152. Section IV.C.2., Coordinated Issue Paper, "Section 482 CSA Buy-In Adjustments", LMSB-04-0907-62 (27 September 2007).
153. Treas. Reg. Secs. 1.482-7T(i)(2)(ii).
154. Treas. Reg. Secs. 1.482-7T(g)(2)(v)(B)(1) and 1.482-7T(g)(4)(i)(F)(1).
155. Preamble, Explanation of Provisions, Sec. 1.482-7T(g)(2)(v), in TD 9441 (IRB 2009-7).
156. Treas. Reg. Sec. 1.482-7T(g)(2)(v)(B)(3).
157. Treas. Reg. Sec. 1.482-7T(g)(2)(x). See also Treas. Reg. Secs. 1.482-7T(g)(1), 1.482-7T(g)(2)(v)(B)(3), 1.482-7T(g)(4)(i)(G), 1.482-7T(g)(5)(ii) and 1.482-7T(g)(6)(ii).
158. Preamble, Explanation of Provisions, Sec. 1.482-7(b)(3)(i), in REG-144615-02 (IRB 2005-40).
159. Make/sell rights include rights to exploit existing intangibles without further development. See Treas. Reg. Sec. 1.482-7T(c)(4)(i).
160. Platform rights (or research & experimental rights) include rights to exploit existing intangibles for purposes of R&D.
161. Treas. Reg. Sec. 1.482-7T(g)(2)(ii)(A) and (B).
162. "APA 2003 Study Guide" (Washington D.C.: IRS, 2003), at 24.
163. Preamble, Explanation of Provisions, C.1.c, in TD 9441 (IRB 2009-7). The Treasury Department and the IRS are considering whether and how the cost sharing rules could be reliably administered on the basis of cash flows instead of operating profits, and whether such a basis is consistent with the commensurate-with-income standard of Sec. 482.
164. Treas. Reg. Sec. 1.482-7T(g)(2)(iv).
165. Treas. Reg. Sec. 1.482-7T(g)(2)(ix)(A).
166. Treas. Reg. Sec. 1.482-7T(g)(2)(ix)(B).
167. Para. 5 German 1983 Transfer Pricing Circular (BStBl I 1983 218) briefly deals with licensing and contract R&D.
168. Sec. 1(3), first and second sentences Foreign Tax Act (*Aussensteuergesetz*). The concepts of unlimited and limited comparability are defined in Para. 3.4.12.7 of the 2005 Transfer Pricing Circular (BStBl I 2005 569).

169. Sec. 1(3), fifth sentence Foreign Tax Act.
170. Sec. 1(7) Regulation on the Relocation of Functions (BGBl I 2008 1680).
171. Sec. 1(3), ninth sentence Foreign Tax Act.
172. Commentary on Sec. 1(3), eleventh sentence Foreign Tax Act, in *Gesetzentwurf Bundesregierung 30.03.2007 BR-Drucksache 220/07 (Unternehmensteuerreformgesetzes 2008)*.
173. R. Schreiber, in H-K. Kroppen, *Handbuch Internationale Verrechnungspreise*, I. Nationale Vorschriften, Funktionsverlagerungsverordnung (Cologne: Verlag Dr. Otto Schmidt, loose-leaf), at margin notes 1, 4 and 60.
174. Sec. 1(3), tenth sentence Foreign Tax Act.
175. Para. 3.9 OECD Guidelines.
176. Sec. 2(2) Regulation on the Relocation of Functions (BGBl I 2008 1680); Para. 2.2.2.1 Draft Circular on Relocation of Functions of 17 July 2009, BMF IV B 5.
177. R. Schreiber, in H-K. Kroppen, *Handbuch Internationale Verrechnungspreise*, note 173 at margin note 74.
178. Para. 2.1.4.1 German Draft Circular on Relocation of Functions of 17 July 2009, BMF IV B 5.
179. Sec. 3(2) Regulation on the Relocation of Functions (BGBl I 2008 1680).
180. Sec. 1(3), sixth sentence Foreign Tax Act; Sec. 3(1) Regulation on the Relocation of Functions (BGBl I 2008 1680).
181. Sec. 3(2) Regulation on the Relocation of Functions (BGBl I 2008 1680).
182. H-K. Kroppen, *Handbuch Internationale Verrechnungspreise*, I. Nationale Vorschriften, Funktionsverlagerungsverordnung (Cologne: Verlag Dr. Otto Schmidt, loose-leaf), at margin note 140.
183. Sec. 1(1), second sentence Foreign Tax Act.
184. Sec. 3(2) Regulation on the Relocation of Functions (BGBl I 2008 1680).
185. A discrepancy between actual and expected profits may be addressed by a periodic adjustment under Sec. 1(3), twelfth sentence of the Foreign Tax Act.
186. Sec. 6 Regulation on the Relocation of Functions (BGBl I 2008 1680).
187. Para. 2.1.4.1 Draft Circular on Relocation of Functions of 17 July 2009, BMF IV B 5.
188. *Id.* at Para. 2.3.2.2.
189. Sec. 1(4) Regulation on the Relocation of Functions (BGBl I 2008 1680). See H-K. Kroppen, *Handbuch Internationale Verrechnungspreise*, note 182, at margin note 138 (noting that it is not necessarily logical for the profit potentials to be determined on a post-tax basis).
190. The regulations do not contain any reference to a tax amortization benefit and do not provide that the tax consequences of a relocation of functions should impact the determination of the profit potentials. However, Para. 2.1.4.2 of the Draft Circular of 17 July 2009, BMF IV B 5, briefly states that the taxes which should be considered in calculating the post-tax cash value should include the tax consequences of the alternatives for both parties. See R. Schreiber, in *Handbuch Internationale Verrechnungspreise*, note 173, at

margin note 73.

191. Sec. 5 Regulation on the Relocation of Functions (BGBl I 2008 1680).

192. Paras. 2.5 and 3.2.2.4 of Draft Circular on Relocation of Functions of 17 July 2009, BMF IV B 5.

193. If the transferor is expecting to realize sustained losses from the function or is no longer able to perform the function itself using its own resources, special rules apply for the calculation of the minimum price. See Secs. 7(2) and 7(3) Regulation on the Relocation of Functions (BGBl I 2008 1680).

194. Alternatively, the arm's length price for a relocation of functions may be based on legal claims for damages, indemnification or compensation as well as claims that could be raised by unrelated third parties, if their possibilities of acting were excluded contractually or de facto. See Sec. 8 Regulation on the Relocation of Functions (BGBl I 2008 1680.) See M. Puls, *Internationales Steuerrecht* (2010), at 89.

195. O. Bjørn, in *FSR's Årsskrift 1990 Skatteret*, ed. Aa. Michelsen (Copenhagen: FSR's Forlag, 1991), at 9, 30.

196. TSS-Circular 2000-10.

197. Reply of Minister of Taxation to the Tax Committee of the parliament, Bill L 62 of 5 November 2003 – exhibit 166 (2003/04).

198. TfS 2006, 312.

199. *Transfer Pricing; kontrollerede transaktioner; værdiansættelse* (Copenhagen: SKAT, 2009). See A.M. Ottosen and E. Vistesén, "New Valuation Guidelines", 17 *International Transfer Pricing Journal* 1 (2010), at 72; J. Bernsen, K. Toftemark and P. Lindholm, "Valuating IP Under New Danish Guidelines", 18 *Tax Management Transfer Pricing Report* (10/22/2009), at 632; J. Bernsen, A.M. Kelstrup and K. Toftemark, *Skat Udland* (2009), no. 364; T. Eskildsen and J. Bygholm, *SR-Skat* (2009), at 250.

200. *Fagligt notat om den statsautoriserede revisors arbejde i forbindelse med værdiansættelse af virksomheder og virksomhedsandele* (Copenhagen: FSR, 2002).

201. Para. 4.4 *Transfer Pricing; kontrollerede transaktioner; værdiansættelse* (Copenhagen: SKAT, 2009).

202. Id. at Para. 4.4.1.

203. Id. at Para. 4.1.1.2.

204. Id. at Para. 4.1.5.2.

205. Id. at Para. 4.1.2.

206. Id. at Para. 4.4.1.

207. Id. at Para. 4.1.2.7.

208. Id. at Para. 4.1.5.3.

209. Id. at Para. 4.1.5.5.

210. Id. at Para. 5.7.

211. Para. 2.123 OECD Guidelines.

212. Id., at Para. 6.25.

213. *Id.*, at Para. 6.20.

214. *Id.*, at Para. 9.94. The OECD has previously stated that an intangible may be valued by examining the profit/loss potential associated with the intangible. See Para. 65 *Transfer Pricing Aspects of Business Restructurings: Discussion Draft for Public Comment* (Paris: OECD, 2008). This statement has not been adopted in the 2010 OECD Guidelines.

215. Para. 9.73 OECD Guidelines.

216. Sec. IV.D., Coordinated Issue Paper, "Section 482 CSA Buy-In Adjustments", LMSB-04-0907-62 (27 September 2007).

217. S.F. Foley, C. Looks and G. Hirsch, "A Prescription for Double Taxation? Restructurings and the New German Exit Charge Mechanics", 18 *Tax Management Transfer Pricing Report* (24 September 2009), at 531.

218. G.V. Smith and R.L. Parr, *Intellectual Property: Valuation, Exploitation, and Infringement Damages* (New Jersey: Wiley, 2005), at 194.

219. *Nestlé Holdings, Inc. v. Commissioner*, 152 F.3d 83, (2d Cir. 1998). The case was not based on Sec. 482 of the Internal Revenue Code.

220. Sec. III.B., Coordinated Issue Paper, "Section 482 CSA Buy-In Adjustments", LMSB-04-0907-62 (27 September 2007). However, in the subsequent case of *DHL Corp. v. Commissioner*, 285 F.3d 1210 (9th Cir. 2002) the Tax Court recognized the use of the relief-from-royalty method noting that "any appeal from our decision in these cases would be to the Court of Appeals for the Ninth Circuit". That is, an appeal would not go to the Court of Appeals of the Second Circuit that had issued the *Nestlé* opinion.

221. *Id.*

222. R. Ackerman, D. Organista and C.M. Mallo, "Intangible Property Migration: Germany's Recent Draft Administrative Principles on Transfer of Business Functions", 18 *Tax Management Transfer Pricing Report* (8 April 2010), at 1253.

223. W.F. Finan and S. Work, "Valuing Intangibles for Transfer Pricing and Accounting Standards Purposes: Similarities and Potential Differences", 17 *Tax Management Transfer Pricing Report* (5 February 2009), at S-2.

224. Paras. 6.14, 7.29, 7.30, 7.33, 8.35, 9.63, 9.72, 9.81, 9.84, 9.91, 9.92 and 9.116 OECD Guidelines.

225. On the importance of incremental product and process innovations for firms, see S. Lalapet, M. Przysuski and H. Swaneveld, "Recognizing the Added Value Created by Incremental Innovation", 12 *Tax Management Transfer Pricing Report* (7 January 2004), at 794; *Pharmaceutical Industry Profile 2009* (Washington D.C.: Pharmaceutical Research and Manufacturers of America, 2009), at 35. For follow-on investment opportunities, see R.A. Brealey and S.C. Myers, *Principles of Corporate Finance* (New York: McGraw-Hill, 7th ed., 2003), at 617.

226. *Veritas Software Corp. v. Commissioner*, 133 TC 14 (2009).

227. Para. 1.64 OECD Guidelines. The 2009 US services regulations violate this principle as the rules on realistic alternatives are expanded to cover economically similar transactions structured other than as service transactions. See Treas. Reg. Sec. 1.482-9(h). In the example given to illustrate the rule, the arm's length test is made on the basis of an alternative transaction which is contrary to the business strategy of the taxpayer. The Treasury Department and the IRS are presumably considering making similar changes to

Treas. Reg. Secs. 1.482-3(e)(1) and 1.482-4(d)(1). See Preamble, Explanation of Provisions, 7. Unspecified Methods, in TD 9278 (IRB 2006-34).

228. This is reflected in the following statement of the IRS with regard to buy-in transactions: “it is exceedingly unlikely that a taxpayer would use information asymmetry for anything other than a tax-advantaged result”. See Preamble, Explanation of Provisions, E.3, in REG-144615-02 (IRB 2005-40).

229. Paras. 6.20 and 6.21 OECD Guidelines; Para. 5.46 Guidance Note 4 (London: International Valuation Standards Council, 2010).

230. District Court of Malmö, decision of 3 March 2009, case 6132-07 (*Ferring AB*).

231. Para. 5.1 *Transfer Pricing; kontrollerede transaktioner; værdiansættelse* (Copenhagen: SKAT, 2009) states that the actual profits, risks, and competitive situation may be taken into account in evaluating the validity of budgets, especially where documentation for the budgets is insufficient.

232. J. Wittendorff, *Transfer Pricing and the Arm's Length Principle in International Tax Law* (Alphen aan den Rijn: Kluwer Law International, 2010), at 239.

233. Correspondingly, Para. 6.22 of the OECD Guidelines emphasizes that where a patent covers only one component of a device, it could be inappropriate to calculate the royalty for the patent by reference to the selling price of the complete product.

234. D.N. Bowen, “Full-Value Methods: Has the IRS Finally Hurlled the Holy Hand Grenade? A Critical Analysis of the Scope of §§ 482, 367(d), and 936(h)(3)(B) in Relation to Goodwill, Going Concern Value, and Workforce in Place”, 37 *Tax Management International Journal* (11 January 2008), at 1; R.V. Femia and D. Blair, “Hazards Ahead: The IRS's Coordinated Issue Paper on Cost Sharing Buy-In Payments”, *Tax Management Memorandum* (12 May 2008), at 195. On “full value” and “partial value” methods, see “APA 2003 Study Guide” (Washington D.C.: IRS, 2003), at Exhibit F.

235. G.V. Smith and R.L. Parr, *Intellectual Property: Valuation, Exploitation, and Infringement Damages*, note 218, at 192.

236. The valuation of past vis-à-vis future R&D is addressed in Sec. III.D., Coordinated Issue Paper, “Section 482 CSA Buy-In Adjustments”, LMSB-04-0907-62 (27 September 2007); “APA 2003 Study Guide” (Washington D.C.: IRS, 2003), at 31.

237. On this basis it is the opinion of the IRS that the general regulations on the residual profit split method are ill-suited to measure the buy-in payment regarding a cost sharing arrangement for the development of intangibles where only one of the parties contributes an existing intangible. See Sec. III.D., Coordinated Issue Paper, “Section 482 CSA Buy-In Adjustments”, LMSB-04-0907-62 (27 September 2007).

238. R.W. Morgan, “Cost sharing agreements – Buy-in Payments and Market Valuations”, 8 *Tax Management Transfer Pricing Report* (15 September 1999), at 449; W.F. Finan, “Reliably Determining a Buy-In Payment under Code Sec. 482”, *Journal of Global Transfer Pricing* (February-March 1999), at 12. See also *Present Law and Background Related to Possible Income Shifting and Transfer Pricing* (Washington D.C.: Joint Committee on Taxation, 20 July 2010), at 113.

239. M.M. Levey, V.H. Miesel and W. Garofalo, “Buy-In and Buy-Out Requirements Present Unusual and Difficult Issues for Cost Sharing Agreements”, 29 *Intertax* 2 (1999), at 28, 31.

240. H.A. Keates, R. Muylle and D.R. Wright, “Temporary Cost Sharing Regulations: A Comment”, 16 *International Transfer Pricing Journal* 3 (2009), at 166, 170.

241. "APA 2003 Study Guide" (Washington D.C.: IRS, 2003), 24 et seq.
242. Paras. 2.80 and 2.131 OECD Guidelines; Para. 2.121 of *Proposed Revision of Chapters I-III of the Transfer Pricing Guidelines* (Paris: OECD, 2009); Treas. Reg. Sec. 1.482-5(d)(4). See W.F. Finan and S. Work, note 223; H-K. Kroppen, note 183, at margin note 138; A.D. Bhasin, "The Temporary Cost Sharing Regulations: An Economic Perspective on Selected Issues", 17 *Tax Management Transfer Pricing Report* (2 April 2009), at 928.
243. Paras. 1.34 and 6.14 OECD Guidelines; Treas. Reg. Sec. 1.482-4(d)(1).
244. Para. 3.9 OECD Guidelines.
245. Transfer Pricing Memorandum (TPM 06), Bundled Transactions (The Canada Revenue Agency, 16 May 2005).
246. E. King and C. Fanaroff, note 142, at 365; A.D. Bhasin, note 242; W.F. Finan and S. Work, note 223; R.W. Morgan, "What's Wrong with the IRS's Investor Model?", 14 *Tax Management Transfer Pricing Report* (29 March 2006), at 1006; D. Laro and S.P. Pratt, *Business Valuation and Taxes* (New Jersey: Wiley, 2005), at 194.
247. B.J. Arnold and P. Dibout, *Cahiers de droit fiscal international*, vol. 86b (2001), at 21, 37, 67 and 69.
248. Sec. 3 B(6) Danish Tax Control Act (*skattekontrolloven*) on transfer pricing documentation makes use of such an approach.
249. Para. 5 *Transfer Pricing; kontrollerede transaktioner; værdiansættelse* (Copenhagen: SKAT, 2009).
250. International Valuation Standard 3 (London: International Valuation Standards Council, 2007).
251. Sec. 90(3), third sentence German General Tax Code (*Abgabenordnung*); Sec. 3(2) documentation regulations (*Gewinnabgrenzungsaufzeichnungsverordnung*, BGBl I 2003 2296).
252. Sec. 3 B(1) Danish Tax Control Act.
253. Secs. 3B(8) and 5(3) Danish Tax Control Act.
254. Sec. 162 German General Tax Code.
255. Critical assumptions for the arm's length test are used in the US and European APA programmes. See Sec. 4.5 Revenue Procedure 2006-9 (IRB 2006-2); Para. 8.2 and Annex F COM(2007) 71 final.
256. Sec. 13-1(2) Norwegian Tax Act. The same applies if the associated enterprise is resident in a country within the EEA, provided that Norway does not have the right to demand information concerning the wealth and income of such person pursuant to an international treaty.
257. Sec. 57 French General Tax Code (*Code général des impôts*).
258. Sec. 6 Regulation on the Relocation of Functions (BGBl I 2008 1680).
259. Sec. 1(3), seventh sentence German Foreign Tax Act.
260. Treas. Reg. Secs. 1.482-1(d)(3)(iv)(H) and 1.482-3(b)(2)(B)(8).
261. Treas. Reg. Secs. 1.482-1(f)(2)(ii)(A), 1.482-3(e)(1), 1.482-4(d)(1), 1.482-7T(g)(2)(iii)(A), 1.482-7T(g)(4)(i)(A) and 1.482-9(h).
262. Preamble: Explanation of Provisions, Sec. 1.482-1(f)(2), in TD 8552 (IRB 1994-31).

263. Treas. Reg. Sec. 1.482-4(d)(1).
264. Treas. Reg. Secs. 1.482-1(f)(2)(ii)(B) and 1.482-4(d)(2).
265. *Bausch & Lomb, Inc. v. Commissioner*, 933 F.2d 1984 (2d Cir. 1991).
266. J.L. Andrus, *Cahiers de droit fiscal international*, vol. 92a (2007), at 629, 641. See also *Claymont Investments, Inc. v. Commissioner*, 90 TCM 462 (2005) (the use by the IRS of a realistic alternative was rejected by the Tax Court).
267. *General Explanations of the Administration's FY 2011 Revenue Proposals* (Washington D.C.: Department of the Treasury, February 2010), at 44.
268. Para. 6.15 OECD Guidelines.
269. Paras. 3.14-3.18 *OECD Task Force report on intercompany transfer pricing regulations under US section 482 temporary and proposed regulations* (Paris: OECD, 1992).
270. The taxpayer's use of a realistic alternative was rejected by the German Federal Fiscal Court in its decision of 23 June 1993, I R 72/92 (BStBl II 1993 801) because the analysis did not take into account the perspective of both parties.
271. J.P. Warner and H.B. McCawley, *Transfer Pricing: The Code and the Regulations* (Washington D.C.: 887 Tax Management, Foreign Income Portfolio, 2004), at A-100.
272. Para. 9.60 OECD Guidelines.
273. Sec. 482, 2nd sentence US Internal Revenue Code.
274. *R.T. French Co. v. Commissioner*, 60 TC 836 (1973); *Bausch & Lomb, Inc. v. Commissioner*, 933 F.2d 1984 (2d Cir. 1991).
275. Sec. 247(2)(b) Canadian Income Tax Act.
276. Paras. 150-151 Income Tax Information Circular 87-2R (Canada Revenue Agency, 27 September 1999).
277. Sec. 1(3), 12th sentence German Foreign Tax Act.
278. Para. 4.9 *Proposals for controlled foreign companies (CFC) reform: discussion document* (London: HM Revenue & Customs, January 2010). See D. Hay, "Controlled Foreign Companies Reform: How the Proposed New Rules Interact with Transfer Pricing Legislation", 17 *International Transfer Pricing Journal* 4 (2010), at 306.
279. J. Wittendorff, *Transfer Pricing and the Arm's Length Principle in International Tax Law*, note 232, at 688.
280. Paras. 3.72, 3.73, 6.28, 6.32, 9.87 and 9.88 and Annex to Chapter VI OECD Guidelines.
281. J. Wittendorff, *Transfer Pricing and the Arm's Length Principle in International Tax Law*, note 232, at 166 et seq. and 689 et seq.
282. *Business Taxation and Competitiveness* (Washington D.C.: IRS, 23 July 2007).
283. Para. 18 Commentary on Art. 7 OECD Model; Sec. B-3 of *2010 Report on the attribution of profits to permanent establishments*, Part I (Paris: OECD, 2010). The selection of a functional analysis as the basis for

the allocation of assets has been made in order to prevent the tax planning that could occur if the management decisions of the enterprise were to be decisive. *Id.* Para. 18.

284. R.J. Vann, "Reflections on Business Profits and the Arm's Length Principle", in *The Taxation of Business Profits Under Tax Treaties*, ed. B.J. Arnold, J. Sasseville and E.M. Zolt (Toronto: Canadian Tax Foundation, 2003), at 133, 143 (arguing that taxation under Art. 9 should be oriented towards Art. 7).

285. Para. 3 2004 Dutch Transfer Pricing Decree (IFZ 2004/680M). See D. Oosterhoff, "OECD Discussion Draft on Transfer Pricing Aspects of Business Restructurings: Netherlands", 16 *International Transfer Pricing Journal* 3 (2009), at 190.

286. Paras. 9.22-9.28 OECD Guidelines. See J. Wittendorff, "The Transactional Ghost of Article 9(1) of the OECD Model", 62 *Bulletin for International Taxation* 3 (2009), at 107, 123.

287. The EU Commission has drawn up formulary apportionment schemes for home state taxation and a common consolidated corporate tax base, the destinies of which are still very uncertain. Both schemes involve the arm's length principle's continuing to be applied vis-à-vis associated enterprises that are resident outside the European Union and associated enterprises that do not qualify as a group company. See S. Cnossen, "Taxing Corporations in the European Union: Towards a Common Base?", in *Tax Reform in the 21st Century*, ed. J.G. Head and R. Krever (Alphen aan den Rijn; Kluwer Law International, 2008), at 74.

288. Para. 6 Preface, OECD Guidelines; Paras. 1.8 and 1.14 OECD Guidelines.

289. Para. 16 Commentary on Art. 7 OECD Model; Para. 53 2010 *Report on the Attribution of Profits to Permanent Establishments*, Part I (Paris: OECD, 2010).

290. *Description of Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal Part Three: Provisions Related to The Taxation of Cross-Border Income and Investment* (Washington D.C.: Joint Committee on Taxation, JSC-4-09, September 2009), at 53.

291. Proposed Sec. 32(5)(7) Danish Corporate Tax Act, set out in Sec. 1(24) of Draft 1 of 1 February 2007 (Journal 2007-411-0081). However, the proposal was not incorporated into the final bill L 213 of 18 April 2007 and the enacted Law 540 of 6 June 2007.

292. Chapter 4, *Proposals for controlled foreign companies (CFC) reform: discussion document* (London: HM Revenue & Customs, January 2010). See D. Hay, note 278.

293. *General Explanations of the Administration's FY 2011 Revenue Proposals* (Washington D.C.: Department of the Treasury, February 2010), 43 et seq. See also "Description of Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal Part Three: Provisions Related to the Taxation of Cross-Border Income and Investment" (Washington D.C.: Joint Committee on Taxation, JSC-4-09, September 2009).

294. Para. 23 Commentary on Art. 1, Para. 13 Commentary on Art. 7, and Paras. 37-39 Commentary on Art. 10 OECD Model.

295. The French Supreme Administrative Court decided that the French CFC rules infringed on the French tax treaty with Switzerland in *Société Schneider Electric*, Appeal 232 276, 28 June 2002. The opposite conclusion was reached by the Japanese Supreme Court on 29 October 2009, case No. 2008 (*Gyou Hi*), 91, the Finnish Supreme Administrative Court in *A Oyj Abp*, KHO: 2002:26, 20 March 2002; the UK Court of Appeal in *Bricom Holdings, Ltd. v. IRC* [1997] STC 1179 (CA); the Swedish Supreme Administrative Court in the *OMX* case (RÅ 2008, not. 61); and the Danish National Tax Tribunal in *Tidsskrift for Skatter og Afgifter* (2004) no. 862.

296. Para. 75, Case C-196/04 (*Cadbury Schweppes*).

297. The Danish parliament has attempted to avoid the *Cadbury Schweppes* test by expanding the Danish CFC regime to apply also to controlled Danish companies. See B. M. Pedersen, "New Tax Rules in Denmark – CFC Taxation and Countermeasures against Private Equity Funds", 61 *Bulletin for International Taxation* 11 (2007), at 489.

298. A. McInnes, "Intangibles Ownership, Arm's-Length Royalties, and the Irrelevance of the Competitive Model", 14 *Tax Management Transfer Pricing Report* (22 June 2005), at 173.