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EU JOINT TRANSFER PRICING FORUM

**COMPILATION OF COMMENTS RECEIVED ON THE
DISCUSSION PAPER ON USE OF ECONOMIC VALUATION
TECHNIQUES IN TP**

Responses received from Brose, EATPL, Finland, Estonia, Netherlands, Repsol Group, Deloitte, Denmark, Germany, Czech Republic, TPCA

Meeting of 9 March 2017

DISCLAIMER:

This is a DG TAXUD working paper prepared for discussion purposes. It does not represent a formal Commission or Commission services position or policy.

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I. Introduction

1. Background

1. Chapter VI and IX of the OECD Transfer Pricing Guidelines (“TPG”) recognise economic valuation techniques as useful for determining the transfer pricing consequences of a transfer of intangibles, rights in intangibles or the transfer of a business/part of a business (an ongoing concern)^{1,2}. The JTPF agreed to evaluate whether there are strengths and weaknesses of the various valuation methods when used for transfer pricing purposes and to identify advantages, obstacles and pitfalls in the practical application of these methods in the TP^{3,4}.
2. A scoping paper (DOC: JTPF/013/2015/EN) was discussed at the meeting in October 2015 and a study was commissioned to Deloitte Belgium which identified the areas for consideration as elaborated in sections II – V below.
3. The objective of this report is to build a bridge between general practice of economic valuation and transfer pricing. It is therefore addressed to both, valuation experts having to apply their expertise in the context of transfer pricing and transfer pricing practitioners who are faced with the application of economic valuation methods.

II. Applying Economic valuation in the context of transfer pricing

1. Differences between valuation for TP and general valuation

4. In the context of transfer pricing and depending on the facts and circumstances, valuation techniques may be used by taxpayers and tax administrations as part of one of the five OECD transfer pricing methods or as a tool that can be usefully applied in identifying an arm's length price⁵. However, when applied in the context of transfer pricing it is necessary to apply them in a manner that is consistent with the Arm's length principle (ALP) and the principles of the TPG⁶. This requirement may create differences between valuation for the purpose of transfer pricing and general valuations which could stem from the scope of the valuation exercise, the interest of the stakeholders, differences in the concepts (e.g. the need to apply a two-sided approach) or the scope of intangibles to be valued. In this context the TPG conclude that valuation made for accounting purposes should be used with caution⁷.

For discussion:

Do you agree with the following recommendations, which aim to explain the meaning of the term "caution"?

Are there aspects which you would like to be added?

1 Chapter IX paragraph 9.94 TPG

2 Paragraphs 6.153 ff. of the Guidance on transfer pricing aspects of intangibles (Chapter VI TPG 2015)

3 Paragraph 2.4 JTPF Program of Work 2015 -2019 (doc. JTPF/005/FINAL/2015/EN)

4 For a glossary of the terms used it is referred to Appendix 8 of the Deloitte study

⁵ paragraph 6.153 OECD TPG (2015)

⁶ paragraph 6.154 OECD TPG (2015)

⁷ paragraph 6.155 OECD TPG (2015)

The following general aspects should be considered when using a valuation which is made for different purposes than for transfer pricing:

- Are the two parties to the transaction regarded as broadly similar to typical market participants or not? (This may have impact on financial forecasts for the two parties, on tax rates considered, etc.)

YES: 11; NO: 0

- Are the assets or the business/part of a business to which the valuation applies comparable to what is considered to be transferred under transfer pricing principles (with reference to perimeter, scope, treatment of goodwill etc.)?

YES: 11; NO: 0

- Are there specific transfer pricing principles that are different from general valuation approaches to take into account (in particular, is the two-sided approach likely to result in a different value)?

YES: 11; NO: 0

- Are the stakeholders' interests likely to bias the valuation and how can the valuation inputs be objectivised (and what level of objective support has been provided in the existing TP / non-TP valuation)

YES: 10; NO: 1

- What is the level of documentation required, both in terms of providing a sufficient background on the transaction and documenting the methodology or methodologies chosen as being the most appropriate as well as the assumptions made for application of such methodology or methodologies.

YES: 10; NO: 0

In case a valuation was made for other purposes than for transfer pricing, its consistency with the ALP and the principles of the TPG should be documented.

YES: 11; NO: 0

ADDITIONAL COMMENTS:

EATPL:

On the documentation required, the same principles of transparency and consistency assumed in the EU JTPF draft document on comparables should also be applied here: description of the transaction (and why it is, or it is not, a realistic option or what convincing reason moves a party to enter into the transaction), methodologies, assumptions, sources used etc. should be sufficiently explained and justified so that independent reviewers can understand what is being done. Needless to say, the proportionality principle is also applicable here, but the fact

that these techniques should be used with 'caution' probably calls for more efforts in terms of documentation on the part of the taxpayer and the tax administration.

ESTONIA:

The first question is a little confusing, not sure if I understood it. Also other questions may need a longer response than just yes or no. But in general, economic valuation is subjective, but "caution" is hard to measure. The valuer may also need judgement of independence and knowledge. But no need to just avoid economic valuation just because it is not done for TP purposes.

FINLAND:

It is important to keep in mind that in Transfer Pricing there is a transaction between two known parties that is being priced. This differs from valuations e.g. for financial reporting purposes, where the aim is to find an objective value for an asset. This difference has an impact on which factors should be considered. If a valuation that is made for other purposes than transfer pricing is used as a basis for determining an arm's length price, any differences in the standard under which the valuation is made and the arm's length principle must be properly considered.

THE NETHERLANDS

- 1) Please include with reference to "lifetime" at question 2 where reference to scope, treatment of goodwill etc is made.
- 2) The third question mentions the two-sided perspective. Is it clear that two valuations must be made?

REPSOL:

In general terms, when using a valuation which is made for different purposes than for transfer pricing any factors that might affect / have incidence in the comparability analysis as per Chapter I of the OCDE TPG should be regarded (e.g. government decisions or policies).

DELOITTE:

By answering 'Yes' we mean that the item/ aspect should be considered when using a valuation made for a different purpose.

GERMANY:

Sometimes the purpose of the questions is not clear. Furthermore, the questions are sometimes not unambiguous formulated or formulated as a closed question. Therefore, the answer "yes/no" does not fit in every case

TPCA:

What is the level of documentation required - It's hard to answer this question more precisely than by the statement the level of documentation is "essential for the credibility of the process

of measuring and understanding the contents of a valuation report by the recipient."

The recipient of the report on the valuation of intangible assets does not have to be a specialist in the field of valuation but he/she should have interdisciplinary knowledge in the area of economics, management, and law for the protection of intangible property.

Requirements for documentation of the valuation are contained in the standards of the valuation of intangible assets issued by various professional associations and research institutes. Evidentiary requirements usually grow when the valuation report is prepared for the court. We do not see a significant difference in the need to document the source of information, the scope of the information obtained and the reasons for the selection of specific valuation methods between the requirements of different valuation standards, recommendations, good practices and TPG.

2. Valuation approaches and methods

2.1 Valuation Methods often relevant in the context of transfer pricing

5. Revised Chapter VI of the OECD TPG regards the application of income based valuation techniques, especially valuation techniques premised on the calculation of the discounted value of projected future income streams or cash flows derived from the exploitation of the intangible being valued (Discounted Cash Flow Methods, "DCF") as particularly useful when applied properly.
6. Valuation techniques based on discounting future economic benefits of the subject of valuation⁸ are:
 - Relief-from-royalty method, sometimes referred to as royalty savings method
 - Premium profit method, sometimes referred to as royalty savings method and
 - Excess earnings method.
7. In addition the following methods are considered as relevant⁹:
 - Historical cost method
 - Replacement cost method
 - Residual value method

2.2 Choice of an appropriate economic valuation method and complementary use of valuation standards

8. The variety of methods theoretically available raises the question which methods should be used after the use of economic valuation was considered useful for a specific transaction.

⁸ for a short non-binding description of the methods and non-binding and illustrative examples see Annex 2A and 2B of the Deloitte study

⁹ for a short description of the methods and examples see Annex 2A and 2B of the Deloitte stud

For discussion:

Do you agree with the following recommendation?

In case the application of an economic valuation method is considered useful, the actual use of economic valuation method as well as the choice of the method should take the following aspects into account:

- the potential strengths, weaknesses, opportunities and threats of each method as described in Annex A¹⁰

YES: 9; NO: 2

- the appropriateness of the method in view of the facts and circumstances of the transaction under review

YES: 11; NO: 0

- the availability of reliable information needed to properly apply the method, and

YES: 11; NO: 0

- whether the complexity and the compliance burden linked with applying the method/obtaining the relevant information is proportionate to the transaction under review.

YES: 9; NO: 0

ADDITIONAL COMMENTS:

ESTONIA:

The value of each of the criteria mentioned above might be subjectively measured.

THE NETHERLANDS:

The first recommendation is not fully clear to us. It seems to refer to a “best method rule” implying a large administrative burden for taxpayers. We would not support such a recommendation which in detail explains why other valuation methods are not used. We would, however, support a recommendation which explains the appropriateness of a chosen valuation method.

REPSOL:

Both MS and taxpayers should be flexible as regards to what method to choose and apply, considering the specific features of the transaction to be valued.

DELOITTE:

Comment on the fourth item: the pragmatic risk assessment strategy or prudent business management principle should be considered (para. 3.82 of OECD TPG) - it may be reasonable to devote relatively less effort for less material transactions.

¹⁰ for a general overview of potential strengths, weaknesses, opportunities and threats and an exemplary overview of methods without any claim to completeness and binding force it is referred to section 3.5.1 and Appendix 2A and 2B of the Deloitte study

DENMARK:

We would like to add that even though it is not a direct requirement to use more than one method, we highly recommend applying different methods in order to stress test the applied primary method

GERMANY:

What exactly means "proportionate" and "reliable" in the given context?

As with transfer pricing methods in general, this report does not require either the tax administration or the taxpayer to perform an analysis under more than one method. A method chosen should only be challenged if it can be demonstrated that the application of another method is clearly more reliable.

YES: 10; NO: 1

ADDITIONAL COMMENTS:**EATPL:**

The application of other methods should be admitted if it leads to a substantially different outcome. Basically some guidance on the meaning of 'clearly more reliable' is probably desirable (maybe in line with the safe harbour in para. 6.193, iii) TPG).

A clear explanation / documentation by the taxpayer on the factors and circumstances considered when selecting a method may be useful to assess whether it was or not the best method. Correspondingly, the tax administration should show why those factors and circumstances should have required the application of other methods.

FINLAND:

One method is generally enough. However, it is not wrong to make a sanity check using another method.

REPSOL:

This would avoid increasing the administrative burden of the taxpayer, making more efficient the review by the Tax Authorities.

DELOITTE:

The expression 'clearly more reliable' may be subjective and therefore leave room for interpretation - need for more objective criteria.

GERMANY:

One can challenge valuation methods only in cases that the Law of thought and economic principles are obviously violated.

It would be useful if the taxpayer prepares a valuation with another valuation method for validation purposes.

9. At present there is a multitude of IP valuation standards set by different standardization bodies¹¹. The report, however, also concludes that the contents and recommendations of these different standards and guidelines are not contradictory in themselves. When applied to transfer pricing a standard to be used for applying an economic valuation method will have to be acceptable by both MS.

For discussion:

Do you think a certain standard can be recommended?

YES: 5 ; NO: 6

Do you think international standards should be preferred to local standards?

YES: 7; NO: 2

If not, would you agree to a recommendation that a valuation using a non-domestic valuation standard should not be rejected for the simple reason of not being the local standard?

YES: 7; NO: 2

ADDITIONAL COMMENTS:

EATPL:

If a most appropriate method rule is endorsed, in my opinion, what should be recommended is to explain why one standard is better than others which means that neither international nor local standards should automatically be rejected. Use of international standards probably will reduce the probability of conflicts in case two or more administrations are involved. The issue is not so different from the problem of pan-European v. local comparables and a similar recommendation makes sense (taking into account the differences between both issues)

FINLAND:

The standard should always be the arm's length principle, not some local standard.

THE NETHERLANDS:

We would not like to recommend a specific standard for various reasons. It would entail a risk of simplification, it would go beyond the guidance of the OECD, and it could hamper the choice for a method by the taxpayer (since the taxpayer has right to choose method and standard). We do suggest to include examples on application of valuation methods as included in the Deloitte report (Appendix 2B)

REPSOL:

¹¹ for a general overview of the national and international standards see Appendix 3 of the Deloitte study. An exemplary overview on potential strengths, weaknesses, opportunities and threats and an overview of standards without any claim to completeness and binding force it is referred to section 3.7.3.

Certain level of guidance would be useful in order to standardise the practice.

MNEs would probably feel more comfortable using international standards than local ones; the latest would increase significantly the work to be done, being also inefficient. Being the purpose of this Forum providing practical solutions, the more standard the recommendations are, the better and usable the final outcome will be.

DELOITTE:

The standard to be used in economic valuations for transfer pricing purpose is "the arm's length principle."

DENMARK:

We do not think one standard can be recommended because it all depends on the matter in hand. The recommendation of a certain standard could limit the tax administrations options in challenging valuations put forward by the taxpayer.

We think that international standards should be the starting point in order to make sure that both the tax administration and the taxpayer have the same basis for the valuation (define the overall framework), but that local standards could be factored in taking the specific facts and circumstances into consideration.

We think that a valuation standard should not be rejected solely based on being domestic or non-domestic. The key factor is whether or not the specific model is considered relevant to apply in the case in hand.

GERMANY:

Maybe it could be helpful if the evaluator refers in appropriate circumstances to the OECD TPG

III. Practical application of economic valuation methods

1. General information about the transaction to which economic valuation methods are applied

10. Before elaborating on the practical application of the respective valuation techniques in the context of transfer pricing it should be recalled that at the outset a thorough factual and functional analysis should be performed to understand the transaction under review. This analysis forms the basis for deciding whether in the specific facts and circumstances valuation techniques may be used.

For discussion:

Do you agree with the following recommendation?

For analysing the transaction to which an economic valuation method may be applied the following information should be available:

- the functional and risk profile before and after the transfer

- *the relevant contracts*
- *an explanation of business and all other reasons for restructuring*
- *information on the business and market strategy*
- *relevant factual details surrounding the transaction*
- *all information that is important to determine the value of the transferred IP correctly and all historical quantitative information behind these assets (costs to develop, former acquisition value if assets were acquired even if long time ago, etc.)*
- *a description of options realistically available to the parties.*

YES: 11; NO: 0

ADDITIONAL COMMENTS:

EATPL:

This has to be documented and the principles of transparency, consistency and proportionality applied to documentation (see comments above in II.1)

FINLAND:

The most important information is, however, expectations regarding the future incomes/cashflows and uncertainty related to them.

ESTONIA:

In general, it may be enough to just recommend the usual documentation requirements and then add here the additional documentation which is specific to economic valuation only.

THE NETHERLANDS:

The Netherlands agrees that first five comparability factors should be assessed (1.36 OECD TPGL 2015). We think this should be part of the recommendation.

REPSOL:

See my comment above on the first box (i.e. taking into consideration all the relevant factors that affect the comparability analysis). Also a proper delineation of the transaction should be considered.

DELOITTE:

All items above are important to consider but in practice the information on all of these factors may not be available. Unavailability of information on all aspects above should not lead to the automatic rejection of the valuation method. A pragmatic approach needs to be taken on a case-by-case basis.

GERMANY:

The quantity of information and which information is needed is dependent on the facts and circumstances of each case and especially of the object of the valuation (e.g. a single asset or a cash generating unit)

2. Key parameters for economic valuation methods

2.1 General

11. Although there are various economic valuation methods and standards it is important to note that from a content perspective they, are quite homogeneous throughout Europe, as well as in the leading third countries (including the US), in the sense that they are built on some common parameters.
12. Key parameters for applying the methods are (i) financial projections of future cash flows including growth rates, (ii) royalty rates, (iii) routine returns, (iv) discount rates and (v) the useful life of intangibles and terminal values. These parameters are of different relevance when applying the valuation methods addressed in this report.

		Financial projections	Royalty	Routine return	Discount rate	Useful life and terminal value
Income-based methods	1. Relief from royalty	Limited (sales/turnover only)	Required	n.a.	Required	Required
	2. Premium profit method	Limited (sales/turnover)	n.a.	n.a.	Required	Required
	3. Excess earnings method	Full forecast	n.a.	Required (asset returns are used instead)	Required	Required
Cost-based methods	4. Historical cost	n.a.	n.a.	n.a.	Required (Capitalisation rate)	n.a.
	5. Replacement cost	Limited (costs only)	n.a.	n.a.	Required	n.a.
	6. Residual value	Full forecast detailed	n.a.	Required (based on functional returns)	Required	Required

2.2 Financial projections and growth rates

13. The reliability of a valuation using financial projections depends on the accuracy of projections of future cash flows or income on which the valuation is based. A key challenge is therefore to assess the reasonableness of a financial projection. The TPG regard projections which are made for non-tax purposes as more reliable than projections made for tax purposes. Furthermore, they provide general guidance on how to assess the accuracy of financial projections and assumptions regarding growth rates¹². The creation and review of a financial projection may be based on different sources of information which are either used directly or as a source for increasing the objectivity and addressing the challenges identified. An exemplary overview is provided in Annex B 1.

¹² paragraphs 6.163 – 1.169 OECD TPG (2015)

For discussion:

Do you agree with the following recommendations?

A reviewer should be provided with data on which the financial projection is based e.g. management accounts as well as with information supporting the assumptions made including growth rates,.

YES: 11; NO: 0

Paragraph 6.178 TPG provides that it may be necessary to evaluate and quantify the effect of taxes on the projected cash flows. Figure 38 (for MS) and figure 42 (for the major trade partners) of the Deloitte study indicate that there are different practices.

Do you think the JTPF should provide additional guidance, e.g. by taking into account guidance issued by major trade partners¹³?

YES: 8; NO: 2

ADDITIONAL COMMENTS:

THE NETHERLANDS:

The Netherlands is of the opinion that local regulations should not be prescriptive for other countries in a MAP/Arbitration procedure. Art. 9 OESO Model is the standard and not the local regulations.

REPSOL:

As long as practical and standard recommendations can be provided, it would be very helpful for Tax Authorities and MNEs that the JTPF could provide them with additional guidance.

DENMARK:

We think that JTPF should provide additional guidance on the tax issue and recommend applying a post-tax approach. When performing valuations between independent parties in a third party transaction it is more or less always on a post-tax basis, which is also in alignment with the existing financial theory.

GERMANY:

[13]: If one want to value Cash Flows you have to take CF after tax. Taxes reduce CF and therefore the present value of the asset in question. Against this background, it won't be helpful taking into account guidance issued only by major trade partners. What goal is being pursued by an additional guidance?

¹³ e.g. US Treas. Reg. 1.482-7(g)(4)(i)(G) state that “In principle, the present values ... should be determined by applying post-tax discount rates to post-tax income...”

2.3 Royalty rate to be taken in the relief from royalty method

14. Some economic valuation methods require the determination of a royalty rate. The TPG provide the general requirement that when economic valuation methods are used in transfer pricing it is necessary to apply them in a manner which is consistent with the ALP and the principles of the TPG¹⁴. For the determination of a comparable royalty rate different sources of information may be used, either directly or as a source for addressing the challenges identified. An exemplary overview is provided in Annex B 2.

For discussion:

Do you agree with the following recommendation?

In cases where the economic valuation method requires the determination of a comparable royalty rate, the following general aspects should be taken into account:

YES: 11; NO: 0

- Exclusivity of the right – parties that have the exclusive right to exclude others from using the intangibles do not have the same degree of market power or influence as parties holding non-exclusive rights;

YES: 11; NO: 0

- Extent and duration of legal protection – for some intangibles that have limited useful life (e.g. patents), the duration of the legal protection affects the expectation of the parties of the future benefits;

YES: 11; NO: 0

- Geographic scope – global rights may prove more valuable than geographically limited rights;

YES: 11; NO: 0

- Useful life – the useful life is impacted by the rate of technological change in a certain industry and by the development of similar or potentially improved products; the useful life is also linked to expected future benefits from the use of intangibles,

YES: 11; NO: 0

- Stage of development – generally intangibles relating to products with established commercial viability are more valuable than those related to products whose commercial viability is not yet established; for partially developed intangibles, the likelihood that the development will lead to future benefits must be evaluated;

YES: 11; NO: 0

- Rights to enhancements, revisions, updates – having access to updates, enhancements can make the difference between deriving short- or long-term advantages from the intangibles;

¹⁴ paragraph 6.154 OECD TPG (new)

YES: 11; NO: 0

- Expectation of future benefit – in cases where a significant discrepancy is observed between the anticipated future benefit of using one intangible as opposed to another, it is difficult to consider the intangibles as being sufficiently comparable in the absence of reliable comparability adjustments; moreover, actual and potential profitability of products or potential products must be considered.

YES: 11; NO: 0

Furthermore, when performing a comparability analysis, the existence of risks related to the likelihood of obtaining future benefits from the intangibles should be considered, especially taking into account the following types of risks:

- Risks related to the future development of the intangibles;*
- Risks related to product obsolescence and depreciation of the value of the intangibles;*
- Risks related to infringement of the intangible rights; and*
- Product liability and similar risks related to the future use of the intangibles.*
- Royalty rates in non-TP valuations should be used with caution.*

YES: 11; NO: 0

ADDITIONAL COMMENTS:

EATPL:

Basically, this replicates para. 6.116-6.128 TPG, where the list of relevant features of intangibles is presented as non-exhaustive (see 6.117). It should have the same nature here.

FINLAND:

In addition it is necessary to know whether the comparable royalty agreements are stand-alone royalty agreements or a part of a larger arrangement.

ESTONIA:

It is not clear, how to measure the value of each and all of those aspects mentioned above.

THE NETHERLANDS

The Netherlands believes that valuable intangibles are unique. In practice numerous comparability problems arise using external royalty agreements/rates. Therefore we wouldn't be in favour of giving guidance on this topic, without saying that it is hard to find useful external comparables, to avoid potential impressions that external comparables can be easily found. Our experience is that internal royalty rate comparables are sometimes available and useful.

REPSOL:

Any further indication as regards to how to perform the economic analysis of such transactions would be interesting: it might be discussed the use of internal comparables, use of commercial databases or any other sources of public information, potential adjustments to increase comparability when some of the above mentioned factors are not fully met

DELOITTE:

If available, these aspects should be considered. In practice however, information on potential comparable third party transactions may be limited. Rarely information regarding all aspects above is available from identified potentially comparable license agreements. Unavailability of information on all aspects above should not lead to the automatic rejection of the potential comparables or of the CUP-based method as the most appropriate method. As also recommended by the OECD TPG in para. 3.38, a pragmatic approach needs to be taken on a case-by-case basis.

2.4 Routine returns

15. Some economic valuation methods require the determination of routine returns. The TPG provide the general requirement that when economic valuation methods are utilised in transfer pricing it is necessary to apply them in a manner which is consistent with the ALP and the principles of the TPG¹⁵. For the determination of a comparable routine returns different sources of information may be used, either directly or as a source for addressing the challenges. An exemplary overview is provided in Annex B 3.

2.5 Discount rate

16. A critical element of all economic valuation methods is the discount rate which converts e.g. a stream of projected cash flows into a present value. It takes into account the time value of money and the risk of uncertainty of the anticipated stream. The TPG stress that the specific circumstances and risks associated with the facts of a given case and the particular cash flows in question should be evaluated in determining the appropriate discount rate. The TPG state that neither taxpayers nor tax administrations should assume that a discount rate based on Weighted Average Costs of Capital ("WACC") or any other approach should always be used. For the determination of a discount rate different sources of information may be used, either directly or as a source for addressing the challenges identified. An exemplary overview is provided in Annex B 4.

For discussion:

The message behind the statement on the use of WACC is that neither this approach nor any other approach should be automatically regarded as superior. Therefore and in light of the importance of the discount rate it is suggested to recommend that the determination of the discount rate needs to be explained. Do you agree with the following recommendations?

When using a discount rate in the context of an economic valuation for the purpose of transfer pricing it should be demonstrated

¹⁵ paragraph 6.154 OECD TPG (new)

- how the discount rate was calculated,

YES: 11; NO: 0

- why this calculation is regarded as appropriate to the facts and circumstances of the case, and

YES: 11; NO: 0

- which information was used to calculate the discount rate.

YES: 11; NO: 0

However, the TPG mention only the WACC formula. Which other kind of formulas do you think could be relevant in this context?

ADDITIONAL COMMENTS:

FINLAND:

Capital Asset Pricing Model, Weighted Average Return on Assets.

THE NETHERLANDS:

- Cash flow-based methods (discounted cash flow or DCF).
- Adjusted Present Value or APV method, in which the future free cash flows including the tax benefit due to net interest cost of debt are discounted as if the company fully funded by equity cash (cost of equity capital "unlevered") ;
- WACC method, in which the future free cash flows excluding the tax benefit to be made at the weighted average cost of capital due to interest deduction in cash. The tax is due to interest deductions reflected in the weighted average cost of capital (WACC);

DELOITTE:

The estimates of discount used by the taxpayer in internal financial planning are useful to consider, including any formulas they may use internally for this purpose.

- Cash flow to equity method, whereby future cash flows that can be effectively distributed to shareholders are discounted levered to the cost base of the equity.
- Any funding has an associated cost of capital.
- Provided applied properly, the value results of the flow of funds methods should be identical.

TPCA:

The construction of WACC mainly assumes the financing of the construction or operation of intangible assets from equity and debt. For start-ups and technology at an early stage of development, equity, and venture capital funds or funds of state aid is a major source of funding, and rarely appear creditors.

In this case and in the case of individual valuation methods, in place of the WACC used are the desired rate of return, occurring in specific funding schemes or related to the extraordinary level of risk remaining at the stage of development or commercialization of the subject of

valuation.

Do you think more guidance should be provided for cases where the use of WACC or another formula has been established as being appropriate?¹⁶

YES: 9; NO: 2

ADDITIONAL COMMENTS:

EATPL:

Once again, taxpayers and tax administration should explain and document the assumptions behind the discount rate (see para. 6.170 TPG)

ESTONIA:

There should be more guidance for discount rate as a critical element

REPSOL:

Given that, for transfer pricing purposes, very limited references exist as regards to the use of valuation methods not based on the 5 OECD TP methods, any further guidance on the use of valuation techniques would be extremely useful.

Many MS might not be used to dealing with this kind of analysis and MNEs do not have certainty when applying them.

DENMARK:

In most cases within the valuation environment the WACC is estimated by use of the capital asset pricing model (CAPM) where the input variables are the risk free rate, a risk component (beta), the market risk premium, the capital structure, the debt margin, the tax rate and in some cases a specific additional risk premium. Hence, there seems to be a strong preference in the market for this method.

GERMANY:

See the previous commentary. Exit taxation should be taken into account.

TPCA:

We see some possibilities to simplify the use of economic valuation methods in the context of transfer pricing if the valuation has been prepared for the purposes of the transaction, using Equitable Value and two-sided valuation methods. It would be sufficient to verify the assumptions and valuation result in the context of functional analysis

¹⁶ potential input on the calculation of the discount rate observed by Deloitte in their EU wide practice are summarized in Annex 4

2.6 Useful life

17. The determination of the useful life of the item which is valued is one of the critical assumptions supporting a valuation model. In the context of transfer pricing is a question to be determined on the basis of all relevant facts and circumstances¹⁷. A further issue in transfer pricing is that in cases where a two-sided valuation is needed the useful life would have to be evaluated from the perspective of both, the transferor and the transferee. For the determination of the useful life, different sources of information may be used, either directly or as a source for addressing the challenges identified. An exemplary overview is provided in Annex B 5.

For discussion:

The application of economic valuation methods is complex and highly fact specific and often based on assumptions rather than on tangible evidence. One avenue to take is to require proportionality as an important aspect when considering the application of economic valuation methods (see above section). Another aspect to consider is whether there maybe potential for simplifying the methods¹⁸.

Do you have concrete suggestions on how the application of economic valuation methods in the context of transfer pricing may be simplified?

ADDITIONAL COMMENTS:

BROSE:

In German tax law there is a so called simplified discounted earnings method applicable in certain circumstances

ESTONIA:

The potential for simplifying the methods should be considered, but no enough experience for any suggestions, maybe a separate survey should be done.

THE NETHERLANDS:

The Netherlands hesitates if simplification is possible. We experience that small differences in parameters can have a large impact on the end result. Will simplification facilitate this?

REPSOL GROUP:

The use of DCF method should be recommended as a general rule. Some guidelines on the steps to follows in order to conduct a valuation would be appreciated. Try to standardize the practice as much as possible, avoiding any local particularities.

¹⁷ paragraphs 6.174 – 6.177 OECD TPG (2015)

¹⁸ At the October 2015 JTPF meeting MS were concerned that a simplified approach to be developed may become the norm, NGMs supported the development of such simplification mechanisms.

DENMARK:

We do not have any concrete suggestions. Valuation is not an exact science so it is very difficult to simplify the framework for the valuation and/or the specific valuation approaches.

GERMANY:

Economic valuation methods in the context of transfer pricing should be simplified. Therefore, it is possible to predefine the valuation elements and give guidance how to calculate exactly the valuation parameters, see para 199 German Valuation Act.

For what reason is this question located in this section (useful life)? This question is a general one. TP should not get more complicated.

TPCA:

We see some possibilities to simplify the use of economic valuation methods in the context of transfer pricing if the valuation has been prepared for the purposes of the transaction, using Equitable Value and two-sided valuation methods. It would be sufficient to verify the assumptions and valuation result in the context of functional analysis.

3. Two-sided vs. one sided valuation

18. As a general principle, a comparability analysis focussing only on one side of a transaction generally does not provide a sufficient basis for evaluating a transaction involving intangibles.¹⁹ Consequently the TPG conclude that depending on the facts and circumstances of the individual cases the calculation of discounted cash flow needs to be estimated from both perspectives of the transaction. Further, the arm's length price will fall somewhere within the range of present values evaluated from the perspectives of the transferor and transferee.²⁰

For discussion:

In practice different approaches could be applied to determine the arm's length price within the range like a fixed rule, e.g. the mid-point or another technique, e.g. bargaining analysis.

Are there other approaches that could be used?

ADDITIONAL COMMENTS:**ESTONIA:**

Maybe just one side of the valuation was faulty

THE NETHERLANDS:

From a theoretical point of view the Netherlands believes the bargaining analyses gives the right answer. The mid-point in most cases not from a theoretical point.

REPSOL:

¹⁹ paragraph 6.112 OECD TPG (2015)

²⁰ paragraph 6.157 OECD TPG (2015)

It should be determined on a case-by-case basis, depending on the specific features of the transactions, information available, quality of such information, etc. Indeed, deviations from the mid-point should be allowed, provided that there are market facts that support them.

DELOITTE:

Bargaining analysis in the strict sense of the word, is highly mathematical and difficult to perform. However, in the sense of reasonability analysis, one may perform assessment of bargaining positions of the parties. Typically it involves a consideration/ review of the options realistically available to the parties of the transaction.

DENMARK:

No suggestions - depends on the case at hand

TPCA:

Mid-point as a clear rule will be the least risky. Bargaining power analysis seems to be difficult to objectify. You might as well consider the degree of reliability (reality) of reasonable alternatives parties to the transaction in the light of the uncertainty reflected in the available data.

Do you think a certain approach should be recommended e.g. the mid-point (as a rebuttable presumption)?

YES: 9; NO: 2

ADDITIONAL COMMENTS:

ESTONIA:

No sure, if the mid-point is the most appropriate, but certain approach might be useful for all

THE NETHERLANDS:

The Netherlands is of the opinion that every point outside the range of values is not at arm's length. Adjustments within the range should only be made with caution. As explained in the previous box bargaining power is very important in this regard

REPSOL:

Not sure, it might help as long as it is not compulsory and flexible approaches, properly supported, are admitted.

DENMARK:

We do not think that a certain approach should be recommended since the value conclusion should be based on the facts and circumstances in the current matter. However, often the midpoint is used as a best alternative but other factors such as the bargaining power of the two parties should be considered and factored into the final value conclusion.

IV. Legislative measures

- 19. The OECD concludes that valuation techniques may be used by taxpayers and tax administrations as part of one of the five transfer pricing methods described in Chapter II or as a tool that can be usefully applied in identifying an arm’s length price.
- 20. It appears that only one country’s regulations²¹, i.e. the US, actually lay down detailed rules on the application of valuation methods to intangibles for transfer pricing purposes. The other countries’ laws may contain corporate finance valuation guidelines, but not specific to transfer pricing purposes. Similarly, the transfer pricing regulations in the nine trade partners do not explicitly refer to valuation of intangible assets (besides the reference and acceptance of the OECD guidelines). The same applies to all EU Member States with the exception of Germany.
- 21. When the scoping paper was discussed at the October 2015 JTPF meeting it was concluded that assessing whether legislative changes are necessary in MS would go beyond the role of the JTPF which is working on practical solutions rather than on legislative aspects.

For discussion:

Instead of assessing MSs' legislative framework and an eventual need for legislative measures, do you agree with the following general recommendation?

MS are recommended to ensure that their transfer pricing legislation allows the use of economic valuation methods as part of one of the OECD transfer pricing methods and as a tool that can be usefully applied in identifying an arm's length price (including measures which are designed to simplify the application).

YES: 11; NO: 0

ADDITIONAL COMMENTS:

REPSOL:

It is essential the commitment of the MS through the incorporation of these methodologies in their legislation.

DELOITTE:

Yes, MS' legislation should allow the use of economic valuation methods. Including "measures to simplify" in national legislation is risky as it may lead to significant differences between countries and to issues of valuation, especially when applied in cross-border transactions.

²¹ see section 5 of the Deloitte study on the use of economic valuation methods for transfer pricing which also contains a description of the US regulations and the German

V. Capacity building

22. Economic valuation is an interdisciplinary study drawing upon law, economics, finance, accounting and investment. This makes it a rather complex exercise. Applying economic valuation methods in the context of transfer pricing is a rather new field which requires sufficient capacities in the tax administrations and on the side of taxpayers.

For discussion:

Do you agree with the following recommendation?

MS and taxpayers should ensure that sufficient resources are available for assessing when the application of economic valuation methods would be appropriate in the context of transfer pricing.

YES: 9; NO: 1

In case economic valuation methods are applied tax administrations and taxpayers should be in a position to apply them properly and to review their proper application to the facts and circumstances of the case.

YES: 10; NO: 1

The following approaches may be considered for building capacity:

- provide training for staff by using internal or external resources

YES: 10; NO: 0

- employ new staff with the required skills

YES: 8; NO: 1

- create the possibility to hire external experts in case expertise is needed to apply or review the application of economic valuation methods

YES: 9 NO: 1

- make skilled personnel available to local/regional entities or tax offices

YES: 10; NO: 1

ADDITIONAL COMMENTS:

EATPL:

Apart from a general recommendation on capacity building (need to make sure that valuations are conducted in an adequate, consistent reliable and transparent manner), I do not think that we should recommend how companies or tax administrations should organize (e.g. by hiring specific people or using external resources, in central or local or regional offices). If some

good practices are identified in specific multinationals or States (in the Deloitte study some examples are given) they can be used as an example of best practices.

It should be taken into account that in some States it may be the case that if valuation is not conducted by someone with the specific expertise, it may be easy to challenge it in court.

FINLAND:

Economic valuation methods are useful in many transfer pricing situations. Using them requires a good understanding of the economic valuation methods and valuation theory. However, it requires also a good understanding of the arm's length principle in order to ensure that the valuations are performed consistently with the arm's length principle (and not according to some other valuation standard that might have similarities with the arm's length principle, but also differences).

ESTONIA:

As for such a very complex exercise, it is hard to be sure if capacity is ever sufficient. Who is in charge of valuing proper application?

THE NETHERLANDS:

Question 3. Only in very exceptional circumstances the Dutch Tax and Custom Administration will consider hiring external expertise. Up till now we have never done that in this field. Important concerns are the independence of the expert (is he/she or the firm involved in other related cases?) and confidentiality of sensitive taxpayer information. Is there a possibility that the EU-JTPF organises a course or symposium on this topic for TP specialist from Member States? Or (more frequently) via the Fiscalis programme?

DELOITTE:

When building capacity, it is important to ensure the use of the ALP standard in the application of valuation methods which will be a new exercise in most member states and for most valuers who currently apply the valuation methods as applicable for non-TP purposes. A major shift in thinking and education is needed.

DENMARK:

We would like to highlight the importance of a domestic valuation paper within the member states that describes the most acknowledged valuation approaches and techniques. This to ensure that the domestic tax administration communicates, to the taxpayers and their advisors, the expected level of requirements when performing a valuation in a transfer pricing context.

GERMANY:

If we accept ALP then we have to acknowledge economic valuation methods. In the ALP we ask for the market price of i.e. an intangible or a business unit. Therefore, we determine the purpose of the valuation. The valuation method follows from the stated purpose. In order to do this valuation one has to take into account accepted economic principles. Another paper or guidance besides textbooks, national standards and the OECD-TPG for valuation is questionable if this paper gives no standardized practical solution. Therefore, economic valuation methods in the context of transfer pricing could and should be simplified.

It could be helpful to establish a "Business Valuation & Crossborder Transactions - Workshop" (see FISCALIS) in order to share knowledge and experience between auditors

Annex A: SWOT Analysis of economic valuation methods for TP purposes

1. Analysis of strengths and weaknesses

Method	Strengths	Weaknesses
1. Relief from royalty	<ul style="list-style-type: none"> - Strongly reflects economic value at time of valuation - relatively easy to use - Key inputs rely on the market data - Amount of data required rather limited 	<ul style="list-style-type: none"> - often a lack of appropriate benchmarks and market data
2. Premium profit method	<ul style="list-style-type: none"> - Strongly reflects economic value at time of valuation - relatively easy to use - Key inputs rely on the market data - Amount of data required rather limited 	<ul style="list-style-type: none"> - often a lack of appropriate benchmarks
3. Excess earnings method	<ul style="list-style-type: none"> - Strongly reflects economic value at time of valuation - due to reliance on individual company data benchmarking may only be needed for objectivizing 	<ul style="list-style-type: none"> - high reliance on individual data with limited possibilities to objectivize the result - more complex to use due to the need for constructing financial models - no direct connection to third party transactions
4. Historical cost	<ul style="list-style-type: none"> - high degree of objectivity due to reliance on actual costs - relatively easy to use - no need for benchmarking due to reliance on actual historical costs - Amount of data required rather limited 	<ul style="list-style-type: none"> - Less connected to economic value at time of valuation - no direct connection to market data and observation

5. Replacement cost	<ul style="list-style-type: none"> - medium degree of objectivity due to reliance on costs - relatively easy to use - Amount of data required rather limited 	<ul style="list-style-type: none"> - Less connected to economic value at time of valuation - Often difficult to benchmark or observe costs required for replacement on the market - Limited connection to market data
6. Residual value method	<ul style="list-style-type: none"> - Strongly reflects economic value at time of valuation - due to reliance on individual company data benchmarking may only be needed for objectivizing 	<ul style="list-style-type: none"> - high reliance on individual data with limited possibilities to objectivize the result - more complex to use due to the need for constructing financial models - no direct connection to third party transactions

2. Analysis of opportunities and threats

Method	Opportunities	Threats
1. Relief from royalty	<ul style="list-style-type: none"> - potential to be used for intangibles with "me too" features, for which reliable comparables can be found - potentially to use for intangibles where comparability can be justified by strong references 	<ul style="list-style-type: none"> - typically not used for intangibles with unique features, for which reliable comparables do not exist
2. Premium profit method	<ul style="list-style-type: none"> - potential to be used for marketing intangibles (brands, trademarks), e.g. for trademarks, where a branded product is priced clearly differently than a non-branded product (or more generally there is clear distinction between forecast for product containing the intangible and one without). - potentially to use for intangibles that will save costs in the future 	<ul style="list-style-type: none"> - typically not used when price premium assessment involves subjectivity (e.g. when there are no clear generic alternatives to branded products, etc.)
3. Excess earnings method	<ul style="list-style-type: none"> - potential to be used for customer contracts, customer relationships and in process research and 	<ul style="list-style-type: none"> - typically not used when definition of "contributory assets" is not clear

	development projects	<ul style="list-style-type: none"> - typically not used when it is difficult to identify all assets and the return attributable to each of them - high possibility of overlap - Typically very limited use in valuation for transfer pricing purposes due to a disconnect with functional and risk analysis (return on contributory assets and not economic returns on functions)
4. Historical cost	<ul style="list-style-type: none"> - potential to be used for internally generated intangibles with no identifiable income streams (e.g. self-developed software, websites) - potentially to use for intangibles in early stages of development, that have not yet resulted in a final product (e.g. early stage pharmaceuticals) 	<ul style="list-style-type: none"> - typically not used for complex intangibles - typically not used for fully developed intangibles that are already generating income streams - typically not used for high-valued marketing intangibles whose value rely on popularity with consumers
5. Replacement cost	<ul style="list-style-type: none"> - potential to be used for intangibles that can be replaced with quantifiable resources (e.g. software) - potentially to use for intangibles in early stages of development, that have not yet resulted in a final product (e.g. pharmaceuticals) 	<ul style="list-style-type: none"> - typically not used for complex intangibles - typically not used for fully developed intangibles (that are already generating income streams) - typically not used for high-valued marketing intangibles whose value rely on popularity with consumers
6. Residual value method	<ul style="list-style-type: none"> - potential to be used for intangibles with unique features - potentially to use when reliable financial projections are available - potentially to use for unpatented technology or customer relations (for which cost- and market- based approaches deem irrelevant) 	<ul style="list-style-type: none"> - typically not used when definition of "routine function" is not clear - typically not used when it is difficult to identify all routine functions and to find reliable comparables in order to asses profitability for each of them - high possibility of overlap - difficult to use reliably when the forecast is highly uncertain

Annex B: Internal and external sources of parameters

1. Financial projections

	Source	Main challenges	Potential solution(s) to challenges
internal	Management projections / financial forecasts	<ul style="list-style-type: none"> • Limited availability of projections for other purposes and, especially of relevant (segmented) financial projections • Uncertainty of projections and, as a consequence, limited accuracy and questionable reasonability of projections • Unreliability of projects based on linear growth rates and past performance due to uncertainty 	<ul style="list-style-type: none"> • Preferred use of internal forecasts created for non-tax purposes • Challenge reasonability of projections: question growth rates including long-term growth, profitability each year • Comparison with industry or competitors and comparables and request for explanations of deviations; finally, potential adjustments based on joint discussion • Focus on key economic and financial indicators for reasonability check • Keep caution in using linear growth rates and past performance indicators.
external	<p>Reasonability check or corroboration with competitors' data or with industry averages in terms of growth rate, etc.</p> <p>Company databases: Bureau van Dijk's Amadeus, Orbis, local databases, (local editions of Amadeus)</p>	<ul style="list-style-type: none"> • Availability and applicability of competitors' and industry data • Applicability of data from competitors and/or industry averages specifically to the financial projections in question 	<ul style="list-style-type: none"> • Challenge and assessment of projections based on economic and financial indicators (industry forecasts / industry expectations) • Cross-check of projections with competitors' data • Cross-check and challenge of the forecast provided, based on Company's record of achievement of forecast • Provide and document justifications of deviations of forecast from industry statistics / forecast from competitors and from the historical statistics (past growth and profitability).

2. Royalty rates

	Source	Main challenges	Potential solution(s) to challenges
internal	<p>Internal comparables: Agreements of a company in the same group with unrelated parties covering the same intangible, under the same conditions</p> <p>External comparables: Information regarding or available third party agreements, known to the Company (such as agreements of competitors), which are in the same industry and are similar/comparable.</p>	<ul style="list-style-type: none"> • Limited availability of internal comparables or any information on third party agreements available to the Company. • If any agreements provided, comparability to the studied transaction and IP in the scope of this transaction. 	<ul style="list-style-type: none"> • Assess comparability of identified agreements according to OECD TPG (geography, products & their profit potential, market level, applications, terms of agreements, etc.)
external	<p>Search and identification of agreements between unrelated parties covering the same type or similar intangibles, under the same or similar conditions, obtain the royalty rate.</p> <p>Agreements databases e.g. RoyaltyStat, RoyaltySource, U-MINE TP Catalyst, LexisNexis</p>	<ul style="list-style-type: none"> • Availability and reliability of third party agreements • Comparability of third party agreements in terms of characteristics of intangibles and of rights transferred, contractual conditions, geographical scope 	<ul style="list-style-type: none"> • Assess and document the comparability analysis of external agreements (according to OECD TPG, i.e. geographical coverage, same applications of IP, etc.) • Cross-check of assumed royalty rate by reference to an operating margin required from sales generated from the use of the IP

3. Routine returns

	Source	Main challenges	Potential solution(s) to challenges
internal	<p>Internal comparable companies (e.g. third party distribution/manufacturing entities performing functions for one entity of the Group and possibly their financial information allowing to assess their rate of return/profitability)</p>	<ul style="list-style-type: none"> • Unavailability of internal comparables and/or their information necessary to calculate routine return 	<ul style="list-style-type: none"> • see JIPF report on the use of comparables in the EU

external	<p>Search and identification of external comparable companies (a group of companies with same routine functional profile) to obtain a benchmark for routine return.</p> <p>Company databases: Bureau van Dijk's Amadeus Orbis; local databases (local editions of Amadeus)</p>	<ul style="list-style-type: none"> • Definition of "routine" function • Comparability in terms of risks and performance of routine functions • Availability of local comparables • Availability of sufficient information for assessing comparability 	<ul style="list-style-type: none"> • Perform functional and risk analysis of tested company (in respect to routine function(s) it performs). • Perform comparable search and comparability analysis according to OECD TPG and JTPF report on use of comparables in the EU. • Document the search and identification of the comparable companies (including all steps of the search and review of potential companies).
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4. Discount rates

	Source	Main challenges	Potential solution(s) to challenges
internal	<p>Information on the discount rate (or inputs used to calculate it) used by Company's management for internal financial management, on the company basis and/or, ideally, in respect to projects with intangibles; or information on different inputs that go into WACC calculations</p>	<ul style="list-style-type: none"> • Appropriateness of the discount rate (other parameters of WACC) that is available from management (special risk of the IP being valued, etc.) and more widely, availability of the discount rate and ability of the company to justify it. 	<ul style="list-style-type: none"> • Assessment of the full rate if provided by management (what is application of the rate provided, etc.) with the intangible valuation in hand. • Analysis and assessment of various inputs for WACC calculations, if provided by managements.
external	<p>Search for relevant information for WACC parameters (company beta, market premium, and risk free rate (all for application of CAPM formula)). Possibly, search on industry-wide WACC's.</p> <p>Financial databases: Bloomberg, Reuters, Capital IQ, S&P, Damodaran</p>	<ul style="list-style-type: none"> • Identification of potential differences between parameters for the Company (i.e. relevant for IP project and reflecting additional risk) and industry-wide parameters. 	<ul style="list-style-type: none"> • Sensitivity analysis (change in the value of analyzed IP) based on the change of parameters for calculation of discount rate. • Detailed justification of the chosen parameters (and their applicability to the analyzed transaction).

5. Useful life

	Source	Main challenges	Potential solution(s) to challenges
internal	Information from the Company regarding the speed of replacement of products containing the IP valued/ speed of development of new technology and its updates. Information on the planned use of the acquired IP by the "buyer" Information on the potential use of the IP by the seller, under the scenario of options realistically available.	<ul style="list-style-type: none"> Level of judgement for finding factors affecting useful life, e.g. technological changes, economic life, functional life. 	<ul style="list-style-type: none"> Reasonability check with external data industry average data and with expert publications but preference to understanding better the specifics of the company, its products, markets, etc.
external	Industry practices / external studies mentioning useful life for similar types of intangibles similar products (for which the IP is used) and considering observations of useful life of intangibles in similar industries and markets Econlit (database of economic academic literature) or search on google for other publically available publications studying useful life, product life cycle, etc.	<ul style="list-style-type: none"> Limited information on the useful life of intangibles in the literature and absence of any specific databases to consult. The characteristics of intangibles studied are unique and thus any industry-wide information (including information on speed of technological changes, product life cycle, etc.) may be inappropriate to use. 	<ul style="list-style-type: none"> Explanation and documentation of selected life including documentation any external sources and their applicability