EUROPEAN COMMISSION
DIRECTORATE-GENERAL
TAXATION AND CUSTOMS UNION
Direct taxation, Tax Coordination, Economic Analysis and Evaluation
Direct Tax Policy and Cooperation

Brussels, October 2015
Taxud/D2

<u>DOC: JTPF/013/2015/EN</u>

EU JOINT TRANSFER PRICING FORUM

DISCUSSION PAPER ON SCOPING THE WORK ON THE USE OF ECONOMIC VALUATION TECHNIQUES IN TRANSFER PRICING

Meeting of 22 October 2015

Contact:
Hartmut Förster, Telephone (32-2) 29.55.511
Morgan Guillou, Telephone (32-2) 29.54.146
E-mail: taxud-joint-transfer-pricing-forum@ec.europa.eu

I. Introduction

1. JTPF Programme of Work

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 application of economic valuation techniques in the context of Transfer Pricing seems, however, rather new for many MS.

The presentation on economic valuation techniques at the October JTPF meeting suggested work of the JTPF on (i) how to price (transactions, aggregation, asset), (ii) how to use the method (pros and cons of methods, crucial aspects like lifetime of IP, risk-factor, interest factor), (iii) which pitfalls to avoid and (iv) where to get the information (which data to access to data for profit projections and how to use).

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].

2. Areas for Consideration/Objectives

One aspect of the EU Commission's Action Plan is the improvement of the transfer pricing framework in the EU. This should include an evaluation and the development of guidance of how these methods can practically be used in the EU in the most efficient way and eventually targeted to some specific transactions.

There are 4 key areas for consideration:

1. Specifics when applying economic valuation techniques in transfer pricing
2. Practical application (focussing on sources of information)
3. Legislative measures
4. Capacity building in tax administrations

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)

The objective is to achieve an enabling framework for the application of these techniques tailored to the EU (as elaborated in Section II), which is competitive with the practices of the EU's main trade partners.

For Discussion:

Are there further aspects to be considered?

3. Working Assumption/Structure

As the outcome of the JTPF work will have to be compatible with the OECD TPG[4], the conclusions of the OECD on the use of economic valuation techniques should be considered as established, meaning that no further evaluation on these aspects is required as long as there is no obvious and fundamental disagreement with these conclusions.

The Directorate General for Research and Innovation created an Expert Group on Intellectual Property Valuation ('The Expert Group'). This Expert Group concluded its work on 29th November 2013 with a final report ('*DG RTD Report'*)[5]. Although this group was not set up for the purpose transfer pricing, especially its conclusions on general aspects of valuating intellectual property should be considered as also relevant for the work of the JTPF on the use of economic valuation techniques as long as the JTPF does not conclude differently.

On aspects of the 4 areas for consideration mentioned above for which the relevant information can be appropriately obtained from Governmental and Non-Governmental Members of the JTPF, questionnaires will be launched. For other relevant items, the Commission intends to do a prior collection of information and data (*e.g.* consultation of experts including the group having worked on the DG RTD Report, surveys and studies).

The work of the JTPF will focus on evaluating the findings from the different sources mentioned above, explore potential consequences and draw appropriate conclusions in form of guidelines, recommendations or propose other legislative and non-legislative measures.

For Discussion:

Do you agree with the proposed structuring of the work?

[4] Article 2 (c) of the Commission decision 26 January setting up the EU JTPF C(2015) 247 final
5 http://ec.europa.eu/research/innovation-union/pdf/KI-01-14-460-EN-N-IP_valuation_Expert_Group.pdf#view=fit&pagemode=none

II. Scope of the Work on Economic Valuation Techniques

1. First aspect: Economic valuation in the context of transfer pricing

1.1 Conclusions of OECD and Expert Group

Revised Chapter VI of the OECD TPG recognises the usefulness of valuation techniques for transactions involving the transfer of intangibles or rights in intangibles. Although not excluding other methods, 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”) are regarded as particularly useful when properly applied. Chapter IX of the OECD TPG recognises the usefulness of valuation methods used in acquisition deals[6].

The Expert Group lists as principal IP valuation techniques under the income approach[7]

- 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.

Each of these techniques is based on discounting of future economic benefits attributable to the subject of valuation[8].

The DG RTD Report concludes that at present there is a multitude of IP valuation standards set by different standardization bodies. The report, however, also concludes that the contents and recommendations of these different standards and guidelines are not contradictory in themselves. When the concrete recommendations are different, this is because of the different purposes and fields of application (*e.g.* valuation causes) of these standards.

The OECD concludes that depending on the facts and circumstances of the case, the value of the discounted value of projected cash flows derived from the exploitation of the intangible should be evaluated from the perspectives of both parties to the transaction and that the arm’s length price will fall somewhere within the range of present values evaluated from the perspective of the transferor and the transferee[9]. The DG RTD Report also mentions the need for a two-sided perspective when applying valuation methods to determine the price of a transaction and observes that in these scenarios “high yardsticks” are set to for substantiating that the price is objective.

[6] Paragraph 9.94 OECD TPG
7 See Annex 1
8 2.4.1 of the Report
9 Par 6.157 . of the Guidance on transfer pricing aspects of intangibles (Chapter VI TPG 2015)

1.2 Prior collection of information and data

Building up on the conclusions mentioned above, prior information could be collected on DCF Methods and,

(i) a preliminary stocktaking exercise carried out at each Member State's level,

(ii) specific challenges when applying these methods for purposes of transfer pricing aspects of intangibles and in the context of business restructurings (transfer of an activity) be identified

(iii) the different standards available in 28 Member States and those accepted internationally for the DCF type valuation techniques considered earlier be explored. This work shall thus establish a stocktaking list of relevant DCF type valuation techniques and related standards applicable and/or used in each Member States

1.3 Action envisaged at JTPF level

It is suggested that the JTPF evaluates the findings and explores whether further guidance can be developed, *e.g.*

- a kind of "most appropriate valuation technique standard" including guidance on when the use of one sided or a two sided valuation may be appropriate
- a typical analytical process (comparable to the 9 step analysis in paragraph 3.4 TPG)
- a simplified process which may be used either directly, as a corroborative method or for the purpose of risk assessment
- in case of a two-sided valuation, criteria for determining a point in the range of agreement

For Discussion:

Do you agree with the proposed actions?

Do you have further suggestions?

2. Second Aspect: Practical Application

2.1 Conclusions of OECD and Expert Group

The DG RTD Report concludes that numerous valuation standards have been issued during the last years concerning different IP rights with different geographical scope and different regulation approach. They have different binding power for professionals, organizations or for certain applications. However, the Expert Group stresses that it is important to note that these standards and guidelines have no contradictory content. Rather, 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 key building blocks.

The Expert Group and the OECD focus on the key building blocks for applying a DCF based techniques, *i.e.* (i) projections of future cash flows including growth rates, (ii) determining a discount rate and (iii) the useful life of intangibles and terminal values. The main general conclusion with respect to these building blocks is that their determination is often highly fact specific and to a certain extent speculative[10].

The input data generally required for applying the techniques will include for example:

- revenues anticipated through use of the asset, an asset group or a business and the forecast share of the market;
- historic profit margins achieved and any variations from those margins anticipated taking account of market expectations;
- tax charges on income derived from the asset, asset group or business;
- working capital, capital expenditure requirements or replenishment costs of the business using the asset; and
- growth rates after the explicit forecast period appropriate to the asset's expected life, reflecting the industry involved, the economies involved and market expectations.
- Discount rates etc.

The need for fact specific application of the techniques consequently requires information on the respective individual cases. The Expert Group concludes that information on the specific facts of a company's intangible property is rarely available in public company reports and – *inter alia* – recommends several measures to improve the situation. However, these measures have to be seen as long term objectives for which it is not clear whether, and if so, when they will actually be implemented. While some data like for instance interest rates may be obtained

[10] Paragraph 6.163 of the Guidance on transfer pricing aspects of intangibles (Chapter VI TPG 2015)

from public sources, other information can often only be obtained at individual company level.

The OECD further concludes that projections made for other purpose than tax purpose are more reliable than those exclusively made for tax.

2.2 Prior collection of information and data

Prior work should identify the various parameters under each of the building blocks (projections of future cash flows including growth rates, determining a discount rate, the useful life of intangibles and terminal values of the valuation techniques). It shall elaborate on the information, which is needed for determining the parameters of these building blocks. The study shall distinguish between information that can be obtained publicly and information, which is only available at individual company level. For information, which is public, the potential sources (databases, information published by government etc.) available in the 28 MS should be screened in all MS, identified and listed.

For information and data, which need to be obtained on individual company's level, the items should be listed precisely. Also, the challenges encountered as part of practical application should be described as well as how these challenges could be addressed (for example, forecasting the future cash flow of a certain intangible requires segmentation of the respective company data, which data is relevant and which approaches are/could be used in practice).

2.3 Action envisaged at JTPF level

With respect to public information, the potential sources (databases, information published by government etc.) available in the 28 MS should be collected by an external provider. The JTPF could assess the information and develop recommendations on their use or their improvement.

With respect to information which is not publicly available (mainly company data), a questionnaire could be launched to Non-Governmental Members and their networks to evaluate whether the information needed can be expected to be commonly available on company level or needs to be specifically produced.

On the side of governments, it could be explored whether the tax administrations in the EU-28 have the legal and practical possibility to access this data.

Case studies and/or templates could be developed for the most common techniques to facilitate their practical use and some modelling approaches envisaged.

For Discussion:

Do you agree with the proposed actions?

Do you have further suggestions?

3. Third aspect: Legislative measures

3.1 Conclusions of the OECD

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.

3.2 Action envisaged at JTPF level

It is envisaged to launch a questionnaire to Governmental Members of the JTPF to assess the situation in MS and legislative measures that may be required on various aspects (scope and situations involved, methods to be used, binding effects, information used and databases etc.).

For Discussion:

Do you agree with the proposed actions?

Do you have further suggestions?

4. Fourth aspect: Capacity building

4.1 Conclusions of OECD and Expert Group

The Expert Group concludes that valuation is an interdisciplinary study drawing upon law, economics, finance, accounting and investment.

The usefulness of valuation techniques for transfer pricing purposes was first recognised by the OECD in the 2010 update of the TPG[11] and can therefore be considered as a relatively new field in the context of transfer pricing and beyond.

A survey was conducted by the Expert Group between March and May 2013 with the purpose of gathering general information about current IP valuation practice. Whereas most respondents from the industry sector (more than 80%) report that their enterprises dispose of dedicated IP managers there is hardly any current IP valuation practice. Only few respondents say that IP is valuated systematically in their companies (~30%). The valuations performed are usually qualitative valuations. Respondents from the industry sector have detected deficiencies in current IP valuation practice mainly that valuation methods are too complex or that valuation methods that are not tailored to their respective industries. Besides they observed a lack of valuation experience and of IP valuation related knowledge. The situation is different for service providers where many of the respondents offer IP valuation as a service to customers.

[11] Chapter IX OECD TPG

4.2 Prior collection of information and data

Prior work should be done to explore the situation in Non EU States, especially the EU's major trade partners like the US and which measures were/are or will be taken to build capacity in these tax administrations and at the level of the industry.

Furthermore, the costs to be expected for valuing a transfer or the use of an intangible with income based valuation techniques should be estimated and significant differences between MS, if any, should be identified

4.3 Action envisaged at JTPF level

There may be already some precedents and examples of practices on how capacity is built on the use of this techniques.

A survey could be launched to governmental members of the JTPF to evaluate the practical experience on the use of these methods and on experience in building up the capacity for the use of these techniques.

Non-governmental members of the JTPF could be asked on whether they consider the results of the 2013 survey of the Expert Group as still reflecting reality.

Based on these findings, further action may be discussed

For Discussion:

Do you agree with the proposed actions?

Do you have further suggestions?