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# Summary

The purpose of this essay is to account for the current legal situation concerning transfer pricing in combination with intangible property. The term transfer pricing refers to prices in a transaction between associated enterprises. The combination of the two subjects is of current interest as there is an increase of controlled transactions as well as trade with intangible property. The method of choice is a legal domestic method. A fictional practise case will be used to show how the evaluation procedure of intangible property has evolved on the side of the regulatory system and there are some major shortcomings in the present legal guidance. The aim is to present a potential new set of guidelines to fill the current gap in the end of this essay.

The Swedish regulations concerning this subject are located in the 14<sup>th</sup> chapter IL. The paragraphs of importance is the 19§, which is referred to as the correction rule which expresses the arm's length principle and the 20§ that regulates what prerequisites that needs to be met in order for enterprises to be seen as associated. The arm's length principle is an international legal principle and an international transfer pricing standard that states that MNE groups should carry out controlled transactions at arms lengths prices. Two cases are of relevance for this subject. In RÅ 1991 ref. 107, also known as "the Shell case", the court stated that the OECD guidelines could provide guidance concerning the correction rule as well as establishing an arm's length price. RÅ 2004 ref.13 establishes that the correction rule has precedence over other general principles regarding income calculation. The OECD guidelines that is most relevant for this subject is the ones concerning the arm's length principle, comparability and transfer pricing methods. It is the firm opinion of the OECD that the best way to establish an arm's length price is to compare the transaction with a reliable and comparable uncontrolled transaction. The comparison should be done with help of the comparability guidelines and of the five approved transfer pricing methods. In addition, the OECD has a specific chapter that concerns intangible property where the difficulties with evaluating the intangibles are highlighted. The fictional company is described as a medium sized Swedish company that has a turnover which is based on intangible property to 98,5 percent. The company wants to licence all the rights to that property to an associated enterprise. In order to decide the value of these intangible property the first step is to choose the best method. By ruling out the market approach and the cost approach, the choice of the most appropriate method was the income approach and the discounted cash flow method (DCF). DCF is not an approved method by the OECD. The focus in the valuation is to determine the risk and the life expectancy, which does not fully agree with the OECD guidelines. When the valuation is finished, we can see that there is little help to be found in the OECD guidelines. The guidelines needs to transform in this area and more focus needs to be on methods based on the income approach, the risk analyse and the determination of life expectancy.

# Sammanfattning

Uppsatsens syfte är att redogöra för nuvarande gällande rätt gällande internprissättning i kombination med immateriella rättigheter. Benämningen internprissättning refererar till priser i en transaktion som sker mellan bolag i en intressegemenskap. Kombinationen av de två ämnena är av intresse då vi kan se en ökning av koncerninterna transaktioner såväl som en ökad handel med immateriella rättigheter. Metoden som jag valt för uppsatsen är rätts dogmatisk. Ett fingerat praktik exempel kommer att användas för att påvisa hur värderingsprocessen av immateriella rättigheter har utvecklats vid sidan av regelsystemet och att det nuvarande systemet av juridisk vägledning har kraftiga brister. Målet är att i slutet på uppsatsen presentera potentiella nya riktlinjer för att kompensera för de nuvarande bristerna.

Den svenska lagstiftningen gällande detta ämne är lokaliserade i 14 kap IL. Paragrafer som är av vikt är 19§, även kallad korrektionsregeln som ger uttryck för arms längds principen och 20§ som anger rekvisiten för bolag som anses vara en intressegemenskap. Armlängdsprincipen är en internationell juridisk princip och en internationell internprissättnings standard som fastställer att multinationella koncerner ska prissätta koncerninterna transaktioner med armlängds pris. Det finns två relevanta rättsfall. I RÅ 1991 ref.107 som även går under benämningen Shell målet där fastställer rätten att OECD:s riktlinjer kan erbjuda vägledning gällande korrektionsregeln och även gällande att fastställa ett armlängdspris. RÅ 2004 ref.13 fastställer att korrektionsregeln har företräde framför andra generella principer rörande inkomst beräkning. De riktlinjer från OECD som har högst relevans för det här ämnet är de som berör armlängdsprincipen, komparabilitet och prissättningsmetoder. Det är OECD:s åsikt att det bästa sättet att fastställa ett armlängdspris är att jämföra transaktionen med en tillförlitlig, jämförbar transaktion mellan oberoende parter. Detta ska ske med hjälp av deras riktlinjer om komparabilitet och godkända prissättningsmetoder. I tillägg har OECD ett kapitel enbart tillägnat immateriella rättigheter där problematiken med att försöka värdera rättigheterna avhandlas. Det fingerade bolaget är beskrivet som ett svenskt bolag av medium storlek vars omsättning baseras på immateriella rättigheter till 98,5 procent. Bolaget vill licensiera alla rättigheter till de immateriella rättigheterna till ett bolag inom samma koncern. För att kunna bestämma värdet på dess immateriella rättigheter är första steget att välja rätt metod. Genom att utesluta marknadsansats och kostnadsansats så faller valet på avkastningsvärdeansats och diskonterat kassaflödesmetod. Diskonteratkassaflödesmetod är inte godkänd av OECD. Fokuset med metoden ligger på att fastställa risken och livslängden vilket inte riktigt går i linje med OECD:s riktlinjer. När värderingen är klar kan vi se att det är lite hjälp att få från OECD:s riktlinjer. Riktlinjerna måste förändras och mer fokus måste läggas på avkastningsvärdeansats, riskanalys och fastställande av livslängd.

# Preface

I have always been fascinated by the connection between law and other factors in the society. How laws are used as a stabilizer when it comes to protect the weak, encourage wanted behaviour and discourage unwanted ones and how you can say so much about a society by looking at their laws and juridical system. This essay is on an international level and does not reflect a national society but an economical society and the essay is in my opinion a child of its time. In today's society, we have moved from a market which trades mainly with tangible assets towards a much more knowledge-based trade. In addition, we can see a clear rapid growth towards a more globalized market. The haste of today's society does not correlate well with the juridical society that has a much slower pace. It is my guess that this a problem that will remain and grow since the society will grow rapidly and the legislation process will continue with its slower procedure. The combination of transfer pricing and intangible property is a subject with little very guidance and it creates a challenge for the tax agencies, the enterprises and anyone else that attempts to find that "right" arm's length price.

Those aspects of the subject together with the challenge and the curiosity of exploring a very new and different area were the reasons the choice fell on this topic. The journey of writing this master thesis has been just as challenging and thought-provoking as I expected. Especially since the economical financial procedure was very unfamiliar to me. I do feel that I have learned a lot from taking on this new and unexplored subject and as a huge bonus I have met some kind and very inspirational people along the way.

On that subject I would start with thanking Oscar Good at the Tax agency for all his time and effort that he has invested in me and this essay. Oscar has with an enormous patience guided me through this subject and his help has been invaluable. I would also like to thank Mats Tjernberg at the law faculty for his important feedback and support. My deepest gratitude also goes to the transfer pricing group at the Tax agency that has allowed me to listen and learned at their meetings. They have also been more than helpful when I have harassed them with all my questions. A special thank you to Åsa Olsson, who has taken out of her free time to answer all of my questions. Further, on, I would like to thank Jesper Barenfelt Tax director at AB Volvo for taking of his most valuable time to meet with me and to let me pick his brain. Finally, I would like to thank Johan Karlhagen for his patience, encouragement and for assisting me with the language. Many thanks for that and more.

# Abbreviations

CAPM	The Capital Asset Pricing Model
COGS	Cost Of Goods Sold
CUP	Comparable Uncontrolled Price Method
DCF	Discounted Cash Flow
IL	Inkomstskattelagen (1999:1229) - Income Tax Act
KL	Kommunskattelagen (1928:370) – County Tax Act
MNE	Multinational Enterprise
OECD	Organization for Economic Cooperation and Development
OECD Guidelines	OECD Transfer pricing Guidelines for Multinational Enterprises and Tax Administrations
PSM	Profit Split Method
R&D	Research and development
TNMM	Transactional Net Margin Method
WACC	Weighted Average Cost of Capital

# 1 Introduction

The world seems to be on a process from an industrial society to a knowledge-based society, which has increased the importance of intangible property.<sup>1</sup> In the meantime the trade between and within multinational enterprises (MNE groups) are increasing which makes the subject of transfer pricing of immediate interest. Transfer pricing is an important issue from many perspectives. The sign of an increased global trade and the important economical and juridical questions that transfer pricing creates for the enterprises and the tax agencies. It is also an important issue for the tax agency since transfer pricing can be a way of transferring money by paying a losing price to an associated enterprise that has its base in a country with lower taxes. There are many different reasons why MNE groups choose to transfer property between their enterprises. The main target with the transfer pricing rules is to prevent tax evasion and to avoid double taxation. One of the major reasons that transactions within associated enterprises are common concerning intangible properties is that these assets have a tendency to be speciality assets. Speciality assets have a high technological sensitivity and there can be many advantages in this way protecting the MNE-groups technological advantage.<sup>2</sup> The transfer of intangible property between associated enterprises plays an increasingly important role for many MNE groups.<sup>3</sup> The emission of this essay is to point out some of the difficulties that arise when we are trying to evaluate intangibles in controlled transactions. The OECD Transfer pricing Guidelines for Multinational Enterprises and Tax Administrations is the main source of guidance in this area. As most international frameworks, the OECD guidelines are quite wide-ranging but the issue of a more thorough regulation of evaluating intangibles is under progress. Although, there are many different interests for the OECD to consider as the organisation has 34 member states. It is therefore hard to tell when a consensus concerning new guidelines can be reached. The current framework regarding evaluation of assets is more suitable for tangible assets and there is not enough on the difficulties with comparing intangibles due to their unique and valuable nature.

The entire world is developing towards globalization, which generates an increased world trade, as well as foreign direct investment. There are also clear signs of a larger division of the production process, which leads to an increased trade in semi-finished products, a market increase in trade, in service and a general increase in the options of production factors. All of these aspects together with other strategic reconstructions and tax considerations encourage the MNE groups to move past national

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<sup>1</sup> Wittendorff, J, Transfer Pricing Arm's Length Principle International Tax Law (2010), s, 593.

<sup>2</sup> Markham Michelle, The Transfer pricing of intangibles (2005), s 10

<sup>3</sup> Shön Wolfgang, Konrad A Kai, Fundamentals of international transfer pricing in law and economics. (2012), s 11



boundaries.<sup>4</sup> The MNE groups play a key part in the globalized economy and according to an OECD estimate MNE groups account for more than 60% of the world trade.<sup>5</sup>

At the moment we are relying on the OECD guidelines, transfer pricing methods together with economic theories and ideas of valuating intangibles, as a result, transfer pricing of intangible property is a difficult and quite uncertain area.

## 1.1 Problem and purpose

The problem circulates around the lack of regulations and guidance in this day's framework concerning the evaluation of intangibles. The OECD is not quite up to speed with the transformation that is taking place in the world, which creates difficulties in the evaluation process. Never the less intellectual property needs to be valuated in spite of the poor legislation. The purpose of this essay is to account for the present legal situation and with a practise case show, how the evaluation procedure has evolved on the side of the regulatory system, and the flaws of the current regulatory system. In addition, my aim is to create this essay as an example of the problems this fast shifting world creates for the legal system. To decide and create new guidelines and laws is an unhurried process and the difference in haste can create vast gaps between theory and practise. Finally, I will give an analysis of the present legal status concerning this subject and give some thoughts and ideas of changes that should be made in the guidelines.

## 1.2 Method

The method in use is a legal domestic method. I have described the legal framework that guides us through the problems of intangibles and transfer pricing today which includes domestic law and the OECD guidelines. By creating the guidelines the OECD aims to establish a standardized network of transfer pricing regulations.<sup>6</sup> The OECD guidelines are a valid source in this subject since the Supreme Administrative referred to the guidelines for guidance in cases concerning the Swedish correction rule. In addition the OECD guidelines are the only international source that is providing guidance in the subject. The guidelines form an international model convention that is based on the agreement of the 34 member states.<sup>7</sup> The guidelines are in many ways used in the same manner as you would use the law, by both enterprises and tax agencies. The essay continues with a description of a fictional company that is built up almost exclusively of intangible property. The company is under reconstruction, which is

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<sup>4</sup> Wittendorff. J (2010), s, 4.

<sup>5</sup> OECD Guidelines art 1.2

<sup>6</sup> Boos, Monica, International transfer pricing, The valuation of intangible assets (2003), s 115

<sup>7</sup> Ibid. s 114

accounted for and analysed, in the following chapter. The example company is built with the aim to illustrate a medium sized, stabile Swedish company. I wanted the turnover to be based mainly on intangible property of more than one kind and that the company would be fully fledged. All these components are used to create a company and a situation where the tangible property would not take up any time and to create room for different possibilities in the valuation process. The main analysis concerns the gap that is between the theoretical legal guidance that are available and the practical procedure that are the most appropriate for this sort of transaction. In the end of the essay there is a description of how a potentially new and evolved set of guidelines concerning intangibles could and should be shaped. As the legal dogmatic method allows the subject to be analysed *de lege ferenda*. Some information in this essay is based on interviews conducted with Oscar Good, Asa Olsson and Jesper Barenfelt. Oscar Good and Asa Olsson works with transfer pricing at the Tax Agency in Gothenburg and Jesper Barenfelt is Tax Director at Volvo AB.

## **1.3 Limitations**

The chapters on the legal frameworks concerning the arm's length price and the intangible are more or less comprehensive, what might be an exception in the customary law where of course exist other cases but it is my conclusion are that the chosen cases are the most significant ones. The OECD guidelines are setting the standards for Transfer Pricing from an international perspective but when it concerns transfer pricing methods there are many other factors that also determine which method that is the best one. In this essay, the choice of method of choice in the fourth chapter is based on which method is most appropriate for this sort of transaction. Concerning the agreement in the third chapter I will not go in to a deeper analysis since this is essay is targeting tax law and not agreement interpretation.

## **1.4 Terms and defenitions**

The subject of Transfer Pricing is in many ways a challenge concerning definitions and wording. There are many different descriptions for the same terms and I will let the terminology on the OECD guidelines be the landmark for this essay. Therefore the term intangible property and intangibles will be used in this essay regardless of the alternative uses such as intellectual property, intellectual assets, intangible rights or intellectual capital, that are used in most the literature that has been relevant for this essay. The OECD definition also decides my choice of the term enterprise, instead of entity or company. The only exception is the company in chapter three that I will refer to as the S Company in order to avoid confusion. The OECD guidelines will also be included in de definition of legal framework in this essay (see Method 1.2).

## 1.5 Disposition

The essay is divided into six chapters starting off with the introduction that you are currently reading. The chapter that follows is an introduction of the subject transfer pricing and the content of the related legal framework that are based on Swedish domestic law and the OECD guidelines. The guidance and regulation concerning transfer pricing and intangible property is attended to within the second chapter. The third chapter is describing the fictional company that are licensing its intangible property to a related British company. The actual valuation takes place in the fourth chapter and is targeting a practical approach of valuation, analysis of risk, life expectancy and arm's length price. Chapter five is an analysis of the full essay and the sixth and final chapter contains *de lege ferenda*.

## 2 Transfer pricing and Intangible property

The term ‘transfer pricing’ refers to prices in transactions among associated enterprises and is one of the principal problems in international tax law.<sup>8</sup> Throughout the early 20<sup>th</sup> century the rules regarding transfer pricing was designed to counteract tax avoidance, as a result of a rather straightforward international trade. The situation looks a bit different in the 21st century when we are looking at a different tax climate and transfer pricing is today much more about the allocation of the income of the MNE group between nations. Because of the technological development and split functions there are more international transactions than it has ever been before.<sup>9</sup> There are many reasons why MNE groups choose to go global, there are the profits of exploring new markets, maximising profits and to be able to secure otherwise unattainable raw material to mention a few.<sup>10</sup>

The regulatory part is quite shattered but aims to avoid double taxation and aggressive tax-planning hence the transactions are made across national boundaries. The idea is that prices and other terms in controlled transactions should be cohesive with prices and terms in a transaction between independent parties, this idea is also known as the arm’s length principle. In Swedish law the foundation concerning this subject is made out of the so-called correction rule in 19§ 14th chapter in the income tax act (IL). The case law is thin and does not provide a lot of guidance. The weak domestic legal situation makes the OECD guidelines so much more valuable.<sup>11</sup>

The combination of transfer pricing and intangible property is something that has been getting more common the past decade. Intangible property is a generic term for all the assets that might not have any book value such as patents, trademarks, trade names, designs and models. It also includes literary property as well as artistic property and intellectual property such as know-how and trade secrets.<sup>12</sup> An intangible property can be developed in at least four different ways; 1) by the owner of the intangible or an independent enterprise, 2) by an related enterprise on service agreement basis, 3) by the owner jointly with an related enterprise through the use of the intangible or 4) by related enterprises thorough CSA.<sup>13</sup> One of the key questions regarding transfer pricing is the aim of finding an arm’s length price for a controlled transaction. The arm’s length price, according to the guidelines requires a comparable uncontrolled transaction, which creates

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<sup>8</sup> Wittendorff. J (2010), s. 3.

<sup>9</sup> Markham. M (2005), s 13-14

<sup>10</sup> Ibid. s11

<sup>11</sup> Handledning för internationell beskattning (2011), s 245.

<sup>12</sup> OECD guidelines (2010) 6(2)

<sup>13</sup> Wittendorff. J (2010), s. 594

difficulties concerning intangible property since most of them are unique assets.

## **2.1 The legal framework concerning the determination of an arm's length price**

As I mentioned in the introduction the OECD guidelines will be included in this category as well as in the chapter that concerns the legal framework of the intangible property.

### **2.1.1 Swedish regulation**

#### **2.1.1.1 The correction rule**

The Swedish regulations are located in the 14<sup>th</sup> chapter of the income tax law (IL), which is the chapter that contains regulations concerning calculations of the enterprise results. The arm's length principle is expressed in Swedish law through the 14<sup>th</sup> chapter 19§ IL. That paragraph is called the correction rule and is the most central part of the Swedish legislation in this area. The correction rule is only applied on cross-border transactions.<sup>14</sup> The correction rule states that if the result of an enterprise is decreased as a result of terms and conditions that have been arranged between companies that would not have been between independent parties the results should be calculated as those terms and conditions did not exist.

Although the rule is only applicable if the company that receive a higher result is obligated to pay their taxes in Sweden, there are reasons to presume that the enterprises are associated according to 20§ 14<sup>th</sup> chapter IL. In addition, it should not be evident of the circumstances that the terms were made for other reasons than the fact that the enterprises are associated.<sup>15</sup>

In order for the relationship between the enterprise to be considered as an associated enterprise according to the 20§ 14<sup>th</sup> chapter IL the chairman on the first entity has to directly or indirectly be a part of the board or supervision of the second enterprise. The chairman can also own a part of that enterprise or directly or indirectly participate in the supervision or are a board member of the other enterprise or if that person owns a part of the other enterprise capital. This also applies if the same persons directly or indirectly participate in the supervision, is a board member on both enterprises, or owns shares in the enterprises capital.<sup>16</sup>

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<sup>14</sup> Wittendorf, Jens, The arm's length principle and fair value: Identical twins or just close relatives? (2011) s235

<sup>15</sup> Handledning för internationell beskattning (2011), s 256

<sup>16</sup> Inkomstskattelagen 14 kap 20§

### **2.1.1.2 Customary Law**

The cases that is relevant for this essay does not concern the valuation procedure. This is because of the obvious reason, which is the absence of rules concerning the valuation procedure in the Swedish legal system. The cases are instead focused on the status and use of the correction rule.

#### **RÅ 1991 ref. 107**

RÅ 1991 ref. 107 is also known as “the Shell case” and is the most comprehensive case concerning the applicability of the correction rule in 43§ 1 KL (Kommunalskattelagen) County Tax Act, nowadays 14:19 IL.

#### **Background**

In the world’s oil market there were seven MNE groups that took dominating positions in the 1970. The Shell group and another MNE was European- based while the other was based in America. The MNE groups conducted business in all levels of oil managing, from drilling to the final costumer sale.

The Shell group has two owning entities, N V Koninklijke Nederlansche Petroleum Maatschappij based in the Netherlands and the “Shell” Transport and Trading Company Ltd in Great Britain. Through the holding company The Shell Petroleum Company Ltd they owned 60 respective 40 percent of the Shell group. Swedish Shell was a so-called operating company and conducted trade with petroleum products on national basis. Shell International Petroleum Company Ltd (SIPC) in Great Britain had been the Shell groups international trading company. According to an extensive tax revision at Swedish Shell has been charged by SIPC between 1976 and 1981 with an amount that extended the prices that would have been agreed between two independent parties.

#### **The Verdict**

The tax commissary (representing the tax agency) claimed that Swedish Shell should be back dated on their taxes during 1976 to 1981 for the amount that they paid SIPC over the arm’s length principle with support of the correction rule in. The Regional Administrative Court based their judgement of the freight price on the market based method, making comparisons with the prices in question and prices in the Woldscale/Average Freight Rate Assessment-system and the price of oil based on the arm’s length price for the OPEC countries. The court made the conclusion that there were no differences between the shell prices and an arm’s length price. The claim for back dated tax was left without consent.

The tax authorities appealed but lowered the claimed amount from 198 322 128 SEK to 110 060 000 SEK.

The Administrative Court was of the opinion that the OECD guidelines would be of valuable guidance concerning the application of the correction rule. The court agreed with the previous judgment, that a market based method was to prefer over a cost base method. The correction rule itself cannot be bound to a certain price method instead; a judgement must be made on a case-by-case basis. The court could not find that an independent demand for a minimum size of the divergence could be interpreted from the correction rule, the point that are of importance is that it is a divergence and not the size of the amount. The comparison was made on the same basis as in the Regional Administrative Court. Concerning the price of oil the court found that the arm's length price had been exceeded regarding the price from 1979 to 1982 for both the freight and the oil. Shell appealed and the case ended up in the Supreme Administrative Court.

The Supreme Administrative Court thoughts on the matter were as follow; the prerequisite in the correction rule that are of interest in this case is the demand for price divergence. In other words that the goods that have been sold to a higher price than what would have been decided between independent parties, as expressed in the arm's length principle. One of the key questions in the case is how the arm's length price should be determined. The interpretation of the wording in the correction rule could generate that the prerequisites is fulfilled as soon as it can be established that the price that has been applied on a transaction that has diverged from the market price. However there is no support for that restrictive interpretation in the preparatory legal work and is not in line with the purpose of the rule, which is to prevent illegitimate transaction overseas. Especially in cases where there are continues transactions between the enterprises it can be better to focus on the assessment of the long term effects based on the grounds and methods of the price determination.

A divergence from the arm's length principle should only lead to correction if the divergence has resulted in an income reduction for the enterprise. The actual range of this prerequisite is not entirely clear. However, the correction rule is not always applicable even in situation were a divergence from the arm's length principle has been established and the prerequisite of income reduction is fulfilled. It is always necessary to take different kinds of business related interests in to consideration before it can be established that a correction is motivated.

The court observed that it is common in controlled transactions with difficulties to find merchandise that can be used in a comparable transaction. Nevertheless, even if it is not a possibility to find a comparable transaction an arm's length price has to be established. If a comparable transaction cannot be found there is no other way than to base the judgement on a hypothetical argument of how two independent parties would have arranged the agreement in a similar situation.

The court also pays attention to the importance of the OECD guidelines. One of the major problems attached to the correction rule is the risk of double taxation. To try to solve the problem the OECD has presented the guidelines. The court gives a special reminder to look at the transfer price methods that is mentioned in the guidelines. In addition, the court points out that the recommendation is to strive to establish an arm's length price based on a comparison with an actual made transaction and not a hypothetical one. The Supreme Administrative Court agrees with the Administrative Court, that even though the guidelines is not binding to the Swedish tax Agency they give a good and well balanced illustration of the problems that taunts the correction rule.

The court establishes that it is important that the terms and conditions of the agreement as well as the situation on the market are established. The Supreme Administrative Court goes through the agreement between Swedish Shell and SIPC as well as the market situation very thoroughly and finds that there are nothing that points at the trade margin that has been taken by SPIC is not to be seen as reasonable. The tax agency's claims are left without consent.

### **RÅ 2004 ref. 13**

This case attends to the question of the correlation between the correction rule and the general principles of income calculation. The case establishes which rule/principle that has precedence.

### **Background**

The parties were the tax authorities and VME Holding Sweden AB (former Volvo BM AB), that will from now on be referred to as Holding AB. The tax authorities claimed that Holding AB should pay a delayed taxation of 8 722 000 SEK as well as an additional tax assessment on the same amount. The amount refers to a cost that has been charged on Holding AB in connection to a repurchase of stock-in-trade within the VME-group. Holding AB is included in the VME-group that has its mother company in Holland and is a main distributor of construction machines. Since 1985 Holding AB has sold construction parts so-called "kits" to VMEA (VME Americas Inc.). VMEA has after the purchase assembled the parts to complete machines and sold them on to North and Central America. In November 15<sup>th</sup> 1988 an oral commission agreement was made between Holding AB and VMEA. The agreement was set in writing November 17<sup>th</sup> the same year and was fully completed in December 1989. In December 1988 Holding AB purchased VMEA:s stock-in-trade for the price of 12 696 909 USD of which 10 095 105 USD concerned the "kits" and other products that VMEA earlier purchased from Holding AB. Later on Holding AB sold the stock-in-trade back in assembled form, machine by machine for a standard price (estimated production costs) that was 13,5 percent higher than price that VMEA paid originally for the stock-in trade. It was also 13,5 percent higher than the price that VMEA paid for the assembled machines in



the last transaction. The price for the repurchase in relation to the other transaction creates a difference of 8 722 000 SEK. The question is if the 8 722 000 SEK is deductible and if the transfer price is acceptable.

### **The Verdict**

The Regional Administrative Court found that Holding AB has made the repurchase in question mainly for business purposes and that the price setting should be seen as legit. The Administrative Court was of a different opinion and stated that the transactions has generated an additional amount of 8 722 000 SEK to VMEA. In order for that cost to be seen as deductible it was necessary that the cost is seen as an expense for Holding AB according to 29§ 1 mom KL. The court was here of the opinion that such an expense did not exist and the verdict from Regional Administrative Court was overruled. In the last instance the court was of the opinion that it was incorrect of the Administrative Court to base the verdict on 29§ 1 mom KL. The correction rule should to be seen as a special regulation concerning international relationships and has therefore superiority over general rules regarding calculating the result of the enterprise. The court was not of the opinion that the tax agency's investigation had shown that the correction rule was applicable in this case. The Administrative Court verdict was overruled in favour of Holding AB.

## **2.1.2 The OECD Guidelines**

The OECD is an advisory organization for economic cooperation. The organization was established in 1961 and has currently 34 member countries as Chile, Estonia, Israel and Slovenia joined in 2010. The OECD Guidelines is made out of nine chapters with the following contents: Chapter I (Arm's length principle), Chapter II (Traditional Methods), Chapter III (Other Methods), Chapter IV (Administrative approaches), Chapter V (Documentation) that were approved in July 1995. In January 1996 Chapter VI (Intangible property), Chapter VII (Intra-Group Services) was added and so was Chapter VIII (Cost Contribution Arrangements) in March that same year.<sup>17</sup> The guidelines also include a commentary to each article and a council recommendation.<sup>18</sup>

The Council recommend the member countries and their tax authorities to follow the Commentaries when they are applying and interpreting treaties that are based on the OECD Model.<sup>19</sup> Neither the OECD Guidelines nor the Commentaries have the status of an international treaty and are not legally binding.

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<sup>17</sup> Wittendorff, J (2010), s107.

<sup>18</sup> Ibid, s, 122.

<sup>19</sup> Ibid, s, 123.

### 2.1.2.1 The arms length principle

The arm's length principle is an international legal principle and an international transfer pricing standard that states that MNE groups should carry out controlled transactions at arms lengths prices. The term arm's lengths price refers to the price that the associated enterprise would have agreed on if they had made a comparable transaction on the open market and not in a controlled transaction. When associated enterprises transact with each other, neither the financial situation nor the price might be directly affected by external market forces in the same way as it would have been between independent enterprises.<sup>20</sup> The arm's length principle follows the method of treating the members of an associated enterprise as they were operating as separate units. In other words, the arm's lengths principle involves a valuation of controlled transactions where the yardstick is a market transaction.<sup>21</sup> In July 1995 the OECD member countries unanimously accepted the arm's length principle and today the principle is to be found in Article 9(1) in the OECD Model Tax Convention that contains the following information:<sup>22</sup>

*“Where condition are made or imposed between the two (associated) enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profit which would, but for those condition have accrued to one of the enterprises, but reasons for those conditions, have not so accrued, may be included in the profit of that enterprise and taxed accordingly”<sup>23</sup>*

The actual term arm's length principle is not mentioned here but the statement is included in the first chapter in OECD guidelines that are simply named “The Arm's Length Principle”. One of the major reasons that several countries have adopted the arm's length principle is because the principle gives a wide standardization of tax treatments for members of MNE groups. The arm's length principle places associated and independent enterprises on moral equal ground for tax purposes.<sup>24</sup> One major problem is that both tax agencies and taxpayers have difficulties to obtain the information needed in order to apply the arm's length principle. The information that is needed in this situation is evaluations of uncontrolled transactions and trade between independent enterprises. This is so that uncontrolled transaction can be properly compared with the transactions and actions between associated enterprises.<sup>25</sup>

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<sup>20</sup> OECD guidelines (2010) 1(2)

<sup>21</sup> Wittendorff, J, (2010) s. 6

<sup>22</sup> Markham. M, (2005) s. 18

<sup>23</sup> OECD Model Tax Convention art 9

<sup>24</sup> OECD Guidelines (2010), 1.8

<sup>25</sup> OECD guidelines (2010), 1(13)

### 2.1.2.2 Comparability

In order to apply the arm's length principle there is a need for a comparable transaction that has been made between independent parties. By definition, a comparison involves the examination of two terms: the controlled transaction in question and the uncontrolled transaction that are considered as potentially comparable.<sup>26</sup> To reach the comparability level that is needed the transactions have to be adequately similar concerning their economical structure. According to the OECD guidelines the transaction is seen as compatible if none of the differences has a noticeable effect, or that reasonable accurate adjustments can be made to eliminate the effect of that difference on the terms that are up for inspection.<sup>27</sup>

When we are trying to evaluate and decide the economical structure of an enterprise we look at the market size, where the enterprise is located and where it has its customers/suppliers. It is also interesting to know the supply and demand, how the competition is at the specific market, government regulation, the cost of production and transport and of course the time of the transaction. Depending on the transaction in question, some of these evaluation factors are more or less important. When the economical structure has been evaluated there is still need to analyse the company's functions, in a so-called functional analysis.<sup>28</sup> The factors that determine comparability of interest here is the assets, the risk, differences in pricing, loss, investments, currency and interest.<sup>29</sup>

It is also of importance to analyse the contractual terms. If there are no written contracts the contractual relationship should be decided from the conduct and economic principles that in general decide the contacts between independent enterprises. If in fact written terms exist, they usually define responsibilities, risks and benefits and how those are divided between the parties. Therefore, the analysis of the contract should be a part of the function analysis.<sup>30</sup>

To be able to choose and decide what other independent transaction is likely to be compatible to the controlled transaction there are two lines of action. The first alternative is to identify a possible comparable transactions made by an independent enterprise. The second step is to collect information and through analysis decide if it is a question of comparable transactions. The other option is to base the selection on companies that are in the same line of business. The factors that are taken into consideration in this process are judged on case-by-case basis.<sup>31</sup>

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<sup>26</sup> OECD guidelines (2010) 3(1)

<sup>27</sup> Handledning för internationell beskattning, (2011), s 260

<sup>28</sup> OECD guidelines (2010) 1(42)

<sup>29</sup> Handledning för internationell beskattning, (2011), s 286

<sup>30</sup> OECD guidelines, (2010) 1(52)

<sup>31</sup> Handledning för internationell beskattning (2011), s 282

### 2.1.2.3 Transfer Pricing Methods

Transfer pricing methods are a methodology that can be used to determine if the terms and conditions between two related parties are consistent with the arm's length principle.<sup>32</sup> Even though the subject of intangibles slightly limits the selection of transfer pricing methods there are still a whole lot to choose from. Selecting the right model is critical and just as difficult as determining a rational value to understand how to use the method.<sup>33</sup> The OECD recommends and describes the use of the comparable uncontrolled price method, the resale price method, the cost plus method, the transactional net margin method and the profit split method<sup>34</sup>.

All together, the decision is an adjustment between how much information you have received concerning the transaction, the information of the company in question and the extent of comparability between controlled and uncontrolled transactions.<sup>35</sup>

The second chapter in the OECD guidelines discuss transfer pricing methods and have made a separation between "traditional transaction methods" and "transactional profit methods".<sup>36</sup> The traditional methods are considered as the most direct when it comes to establish an arm's length price. As a result, the traditional methods are preferred to the transactional profit methods by the OECD.<sup>37</sup> Although there are situations where transactional profit methods are found to be more suitable than the traditional methods. As an example, it can be more appropriate with a transactional profit method when each of the parties makes valuable and unique contributions to the controlled transaction.<sup>38</sup> However, methods that are based on profits can only be accepted as long as they are compatible with Article 9 of the OECD Model Tax convention (arm's length principle) especially with consideration to the comparability aspect.<sup>39</sup>

The MNE groups reserves the liberty to apply methods that are not described in the guidelines. As long as, these other methods result in prices that are fulfilling the arm's length principle. These other methods should not be used in substitution for OECD-recognised methods when the OECD methods are more appropriate to the fact and circumstances of the case.<sup>40</sup>

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<sup>32</sup> Handledning för internationell beskattning (2011), s 267

<sup>33</sup> Damodoran. A, (2002), s 946

<sup>34</sup> The OECD Guidelines, chapter. 3

<sup>35</sup> Handledning för internationell beskattning (2011), s 268

<sup>36</sup> OECD guidelines, (2010) 2(1)

<sup>37</sup> OECD guidelines, (2010) 2(3)

<sup>38</sup> OECD guidelines (2010) 2(4)

<sup>39</sup> OECD guidelines (2010) 2(6)

<sup>40</sup> OECD guidelines (2010) 2(8)

### 2.1.2.3.1 Traditional methods

#### Comparable uncontrolled price method

Comparable uncontrolled price method is also known as the CUP method. The CUP method compares the price charged for property or services transferred in a controlled transaction to a price that are charged for a property or services transferred in a comparable uncontrolled transaction.<sup>41</sup> When it is possible to locate a reliable comparable transaction the CUP method is the most reliable way to establish an arm's length price and therefore the CUP method is preferred over all other methods.<sup>42</sup> The CUP method is especially reliable when an independent enterprise sells the same product as is sold between two associated enterprises.<sup>43</sup> The problem can be to actually find a transaction between independent enterprises that have the similarity that is needed. As an example, minor differences in the property in the transaction could affect the price and the nature of the business.<sup>44</sup>

#### Resale price method

The price method is based on the price of a product that has been purchased from an associated enterprise and then resold to an independent enterprise. That price (the so-called resale price) is reduced by an appropriate gross margin. (the resale price margin). That margin is demonstrating the amount out of which the reseller would want to cover its selling expenses and then make a reasonable profit. What is left after subtracting the resale price margin can be regarded as an arm's length price for the original property transaction between the associated enterprises.<sup>45</sup>

If the principles concerning comparability is to be fulfilled when using the resale price method one of two conditions needs to be met: "*a) none of the differences (if any) between the transactions being compared or between the enterprises undertaking those transactions could materially influence the resale price margin to the open market; or b) reasonable accurate adjustments can be made to eliminate the material effects of such differences*".<sup>46</sup> Normally when the resale price method is used, fewer adjustments are needed to account for product differences than under the CUP method. This is because smaller product differences are less likely to have as an effect on profit margins as it has on the price.<sup>47</sup> Nevertheless, even though it can be allowed with broader product differences in the resale price method, the property transferred in the controlled transaction must still be compared to what is being transferred in the uncontrolled transaction.<sup>48</sup>

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<sup>41</sup> OECD guidelines (2010) 2(13)

<sup>42</sup> OECD guidelines (2010) 2(14)

<sup>43</sup> OECD guidelines (2010) 2(18)

<sup>44</sup> OECD guidelines (2010) 2(15)

<sup>45</sup> OECD guidelines (2010) 2(21)

<sup>46</sup> OECD guidelines (2010) 2(23)

<sup>47</sup> OECD guidelines (2010) 2(23)

<sup>48</sup> OECD guidelines (2010) 2(25)

It is important to remember that a resale price method is more accurate when it is realised within a short time of the reseller's purchase of the goods. The more time that passes by between the original purchase and the resale the more likely it is that other factors has to be taken in to account in the comparison.<sup>49</sup>

### **Cost plus method**

The cost plus methods starts off with the costs that are acquired by the supplier of the property in a controlled transaction for the property transferred to an associated purchaser. A proper cost plus mark-up is then added to this cost, to make an appropriate profit with consideration of the functions and the market conditions. After adding the cost plus mark up an arm's length price of the original controlled transaction is created. The cost plus method is probably most suitable in situations where semi-finished goods are sold between associated enterprises and where associated enterprises have made long-term buy-and-supply arrangements or when the controlled transaction is the provision of services.<sup>50</sup>

The supplier's cost plus mark-up should preferably be established by comparison to the cost plus mark-up that the same supplier acquires in a comparable uncontrolled transactions (internal comparable) . It is also possible to use the cost plus mark-up that would have been earned in comparable transactions by an independent enterprise (external comparable).<sup>51</sup> If the principles concerning comparability should be fulfilled when using the cost plus method one of two conditions needs to be met: "*a) none of the differences (if any) between the transactions being compared or between the enterprises undertaking those transactions could materially influence the cost plus margin to the open market; or b) reasonable accurate adjustments can be made to eliminate the material effects of those differences.*"<sup>52</sup>

It is important, when applying the cost plus method to pay attention to apply a comparable mark up to a comparable cost. For that purpose, it is particularly important to consider the many differences in the level and type of expenses and that the focus lies on the direct and indirect costs of the production.<sup>53</sup>

### **2.1.2.3.2 Transactional profit methods**

#### **Transactional net margin method**

The transactional net margin method also referred to as TNMM inspects the net profit comparative to an appropriate base that a taxpayer realises from a

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<sup>49</sup> OECD guidelines (2010) 2(30)

<sup>50</sup> OECD guidelines (2010) 2(39)

<sup>51</sup> OECD guidelines (2010) 2(40)

<sup>52</sup> OECD guidelines (2010) Chapter 1

<sup>53</sup> OECD guidelines (2010) 2(45)

controlled transaction. The TNMM methods function is similar to the cost plus and resale price method in the way that it in way that to be reliable the TNMM method has to be applied in the same manner as the cost plus and resale price method. The net profit indicator of the taxpayer from the controlled transaction should ideally be established by reference by internal comparables.<sup>54</sup>

The TNMM method is not preferred in transactions where each party makes a valuable unique contribution. In the case, a transactional profit split method will usually be the most appropriate method. Although the TNMM method can be applied in cases when only one of the parties makes all the unique contributions. In that case the tested party should be the less complex one<sup>55</sup> There are many cases where one party make contributions that are not unique. As an example, the party can be using non-unique intangibles. In those cases, it might be a possibility to fulfil the comparability requirements and apply a traditional transaction method or the TNMM method as the comparable would to use a comparable mix of non-unique contributions.<sup>56</sup>

One of the strength of the TNMM method is that it is only necessary to test only one of the associated enterprises. Although, a comparability analysis must always be performed to establish the most characteristic transaction between the parties and based on that, choose the most appropriate transfer pricing method.<sup>57</sup> On the other hand, one of the weaknesses of the TNMM method is that the application of any transfer pricing method necessitates information of uncontrolled transactions that might not be presented at the time of the controlled transaction. This can make it particularly difficult for taxpayers to use the TNMM method at the time of the controlled transaction.<sup>58</sup>

### **Profit split method**

The profit split method first identifies the profits that need to be split for the in the controlled transactions in (the combined profits). The method then splits those combined profits between the associated enterprises on an economically valid basis estimates based on profits that would have been anticipated and reflected in an agreement that are made at arm's length.<sup>59</sup> The major strength of the profit split method is that it can offer a solution for highly combined operations for which a one sided method would be inappropriate.

The profit split method might be the most appropriate in cases where both of the parties make unique and valuable contributions to the transaction. In that situation, independent parties might want to share the profits from the transaction in proportion to their contribution and therefore a two-sided

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<sup>54</sup> OECD guidelines (2010) 2(58)

<sup>55</sup> OECD guidelines (2010) 2(59)

<sup>56</sup> OECD guidelines (2010) 2(60)

<sup>57</sup> OECD guidelines (2010) 2(63)

<sup>58</sup> OECD guidelines (2010) 2(65)

<sup>59</sup> OECD guidelines (2010) 2(108)

method such as the profit split might be more appropriate. In addition, when dealing with unique and valuable contributions it can be insufficient to apply another method.<sup>60</sup>

In the case where there are no direct indications of how independent parties would have split the profit in a comparable transaction, the allocation of the profit can be split based on the functions (such as the used assets and assumed risks) between the associated enterprises themselves.<sup>61</sup> Another strength of the profit split method is its flexibility in the way that it takes in to account specific and unique circumstances of the associated enterprise but it can still represent an arm's length approach to the extent that it reflects what an independent enterprise realistically would have done during the same circumstances.<sup>62</sup>

On the other hand, one of its weaknesses of the method is the difficulty of its application. Both taxpayers and tax agencies can have difficulties to accessing the information that is needed from foreign associates. It might also be difficult to measure the combined returns and costs for the associated enterprises that are participating in the controlled transaction. It would be necessary to see stating books and making adjustments between different accounting practises and currencies.<sup>63</sup>

## 2.2 The legal framework concerning intangible property

To be able to determine an arm's length price for intangible property a definition of intangible property is needed. The issue of identifying intangibles is a matter of both the OECD and domestic law. As the definition on intangibles in the OECD guidelines does not have the status of law but may be taken in to consideration for the purpose of the domestic law definition.<sup>64</sup> The guidance that are at hand regarding domestic law definition is in the trademark act (varumärkeslagen 2010:1877) that defines the definition of trademarks, the Patent Act (patentlagen 1967:837), The pattern protection Act (Mönsterskyddslagen 1070:485) and the Copyright Act (Lag om upphovsrätt till litterära och konstnärliga verk 1960:729). The domestic definition is basically the help that are given by the Swedish legal system. The intangibles that do not receive any help from the Swedish laws are the ones that are in-between legal intangibles and economic intangibles such as know-how, goodwill and trade-secrets. Concerning special attendance or guidance regarding intangible property and the aim of

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<sup>60</sup> OECD guidelines (2010) 2(109)

<sup>61</sup> OECD guidelines (2010) 2(111)

<sup>62</sup> OECD guidelines (2010) 2(112)

<sup>63</sup> OECD guidelines (2010) 2(114)

<sup>64</sup> Wittendorff, J, (2010) s. 615



establishing an arm's length price the OECD guidelines is the help that is offered.

## **OECD Chapter VI**

The sixth chapter headline reads: "Special Considerations for Intangible Property" and starts with establishing that intangible property is in great need of special attention as of the fact that they are so very difficult to evaluate for tax purposes.<sup>65</sup>

### **Definition**

The term intangible property incorporates rights to industrial assets such as patents, trademarks, trade names, designs and models. It also includes literary property as well as artistic property and intellectual property such as know-how and trade secrets. Intangible property is assets that might not have any book value at the enterprise balance sheet but can still possess considerable value. They might also be associated with considerable risk.<sup>66</sup>

### **Commercial Intangibles**

Commercial intangibles include patents, know how, models and designs that are being used in order to produce a product or provision for a service. They are in themselves business assets that are being transferred to customers or used in the operating business. There are two categories of commercial intangibles; marketing intangibles and trade intangibles.<sup>67</sup>

### **Marketing intangibles**

Marketing intangibles include trademarks and trade names that assist in the commercial exploitation of a product or service. Example of market intangibles are customer lists, distribution channels and unique names, symbols or pictures that have an important promotional value for the product that it concerns. Some of these market intangibles are protected by law and can only be used with the owner's consent. The value of a market intangible depends on many different factors, such as the reputation and credibility of the trade name or the trademark that is developed by the quality behind the trade name or trademark and the R&D that are in progress.<sup>68</sup>

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<sup>65</sup> OECD guidelines (2010) 6(1)

<sup>66</sup> OECD guidelines (2010) 6(2)

<sup>67</sup> OECD guidelines (2010) 6(3)

<sup>68</sup> OECD guidelines (2010) 6(4)

## Trade intangibles

Commercial intangibles other than marketing intangibles are referred to as trade intangibles. Trade intangibles are many times created by costly and risky R&D and the developer normally tries to recover the costs on these activities and acquire a return through sales or license agreements. The developer can conduct the research on its own or on behalf of some other group member under a research contract.<sup>69</sup>

It is important to pay attention to whether or not a trade or market intangible exists and when it exists. As an example, not all R&D produces a valuable trade intangible and not all marketing activities result in a marketing intangible. It can be very difficult to determine when an investment has successfully resulted in a business asset and then to calculate the economic effect of that asset for a specific time period.<sup>70</sup>

## Applying the arm's length principle

The general guidance for applying the arm's length principle can be found in chapter I, II and III and are equally important to determine an arm's length price between associated enterprises for intangible property.<sup>71</sup> When an arm's length price for intangible property is to be determined, it is important for the sake of comparability to take in to consideration the perspective of both the transferor and the transferee. From the transferor's perspective if an independent party would transfer their property for that price and from the transferee if a comparable independent enterprise would be willing to pay such a price.<sup>72</sup>

Including the factors that are mentioned in OECD's second chapter concerning comparability some additional factors are needed to take in consideration when intangible properties are concerned. Special considerations should be given to what kind of benefits that follows the intangible property, whether the right to use the property exclusive or not, if the right demands further investments, what kind of costs that are related to marketing and other costs related to the new right.<sup>73</sup>

In some cases intangible property are being bundled together in a package contract that can include rights to patent, trademarks, trade secrets, and know how. If that is the case, the different intangibles in the package might need to be considered separately to establish the correct arm's length price. It is also important to take in to the calculation the value of different services such as technical assistance, training for employees and other services that the developer may deliver in connection with the transfer of the

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<sup>69</sup> OECD guidelines (2010) 6(3)

<sup>70</sup> OECD guidelines (2010) 6(6)

<sup>71</sup> OECD guidelines (2010) 6(13)

<sup>72</sup> OECD guidelines (2010) 6(14)

<sup>73</sup> Handledning för internationell beskattning (2011), s 305

intangibles.<sup>74</sup> All these factors can make it difficult to properly separate the intangibles and determine the correct price for each piece.

### **Calculation of an arm's length consideration**

When applying the arm's length principle to a controlled transaction involving intangible property some special factors should be considered. These factors include the expected benefits from the intangible property, limitation in the geographical area in which the rights are allowed to be exercised, possible export restrictions, the start-up expenses and the development work that would be required in that market.<sup>75</sup> When the intangible property in question is a patent, it is important to take the nature of the patent as well as the degree and length of the protection in to consideration. And to remember that new patents may be developed speedily on the basis of old ones which might give the intangible property a prolonged protection.<sup>76</sup>

When an arm's length price is to be decided in the case of licensing or a sale of intangible property it is possible to use the CUP method if the same owner has transferred or licensed comparable intangible property under comparable circumstances to independent enterprises.<sup>77</sup> And when it comes to sales of goods incorporating intangible property, it is a possibility to use both the CUP method and the resale price method.<sup>78</sup> In transactions where highly valuable intangible property is involved there might be difficult to find a comparable uncontrolled transaction and therefore it can be difficult to apply the traditional methods and the transactional net margin method, especially when both parties owns valuable intangible property that are used in the transaction. In those cases, the profit split method might be the best alternative although it might be practical problems in its application.

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<sup>74</sup> OECD guidelines (2010) 6(18)

<sup>75</sup> OECD guidelines (2010) 6(20)

<sup>76</sup> OECD guidelines (2010) 6(21)

<sup>77</sup> OECD guidelines (2010) 6(23)

<sup>78</sup> OECD guidelines (2010) 6(24)

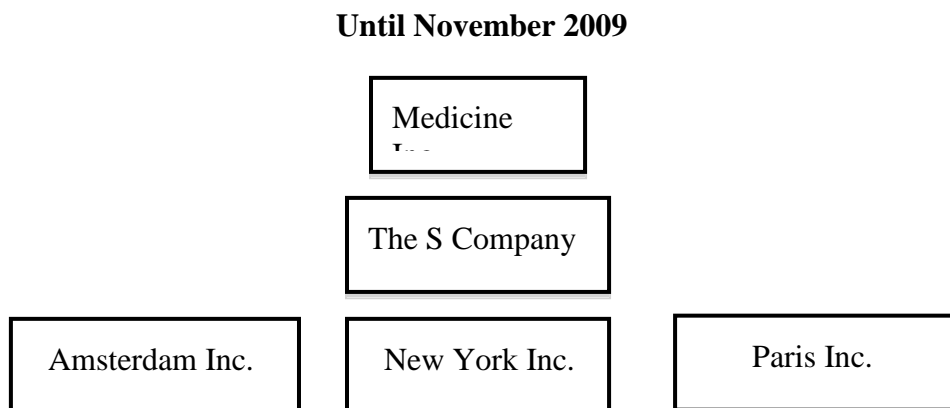
# 3 The company

## 3.1 Introduction

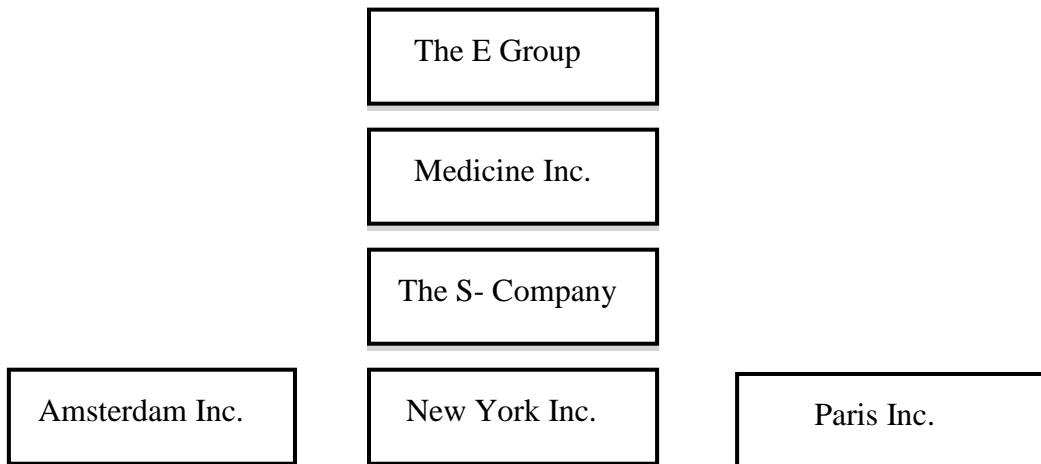
The reconstruction of this enterprise takes place in 2012 and is a transaction of intellectual property based on a licence agreement from one of the Swedish subsidiary companies (from now on S-Company) to a English MNE (from now on E-Group). The agreement states that the E-company receives the right (from now on “the rights”) to use all the know-how and trademarks for the Product t in the purpose to produce, sell and conduct R&D. The E-Company wants full ownership over the outcome of the R&D that they prosecute.

## 3.2 The MNE group

The Swedish MNE group consists of the S-Company that is owned by Medicine Inc. and three subsidiary companies to the S-Company. The subsidiary company that is active has its base in America and its function is to work as a distributor for the S-Company. In 2010, Medicine Inc. was contacted by the E-Group that was interested in a purchase of the above-mentioned enterprises. Later on that year the Swedish companies became part of the E-group.



November 2009 – Present date



### 3.3 The S-Company

The S-Company is prosecuting its own R&D and is handling its own sales and manufacturing. The S- Company also owns all of its intangible property (a so-called fully fledged company). Around 60 percent of the S-company's sale goes through external distributors. The company's turnover reaches just over 200 million SEK and is considered to be very stable. The S-Company has been active within the medicine industry manufacturing the product in almost 15 years.

### 3.4 The assets

The intangibles was once a patent with functions concerning the world of medicine but is now when the patent expired a combination of the brand name (from now on referred to as 'the Product'), the production 'know how' linked to the product and the customer list. The income that can be derived from the Test makes 98,5 percent of the S-company's turnover. The additional 1,5 percent is mainly coming from freight. The Product is a successful device that measures the level of white blood cells in an extraordinary fast, reliable and simple way. The fact that the patent is no longer active will not have a negative effect since the Test has a very strong brand name and a well-established trademark. Subsequently the intangible property is made out the brand name, which is the Products trademark, the Products figure mark that are registered in the S-company's major markets,

the Production know-how which is the technique applied on the production process of the Product and at last the customer list.

## **3.5 The business development**

In November 2010, the Swedish MNE-group was acquired by the English MNE-group and in the beginning of 2011 they were starting to cancel the agreements with the external distributors. In connection to the cancellations some of the staff is being let off. Later on in 2011, a decision of moving the R&D to England is made. The reason for the move was logistic and to gain better control over the production and the R&D. In the beginning of 2012 all production and R&D are being moved to England and more staff is being discharged from the S-Company and the staff that has special knowledge about the Product are being relocated to the E-Group. The aim is to activate the agreement the 1<sup>st</sup> of June 2012 and the S-Company's profit will be entirely based on royalties from the Product when the agreement is completed. This development generates a situation where the aim is to transfer intangible property between associated enterprises.

## **3.6 The phase out argeement**

### **3.6.1 The agreement**

The S-Company and the E-group work out a license agreement. Their wish is to phase out the compensation for the Product over a suitable number of years. Whether or not it will be possible to do so in this situation remains to be seen.

1. S-Company is the holder of know-how that is related to the manufacturing of the Tests range of products. The E-Group wishes to acquire the rights under the S-Company's know-how and the related technical assistance for the aim of developing, manufacturing, using and selling the Product.
2. The S-Company grants to the E-Group a worldwide, exclusive and non-transferable license without the right to sublicense to use the trademarks and the know-how. This license is for manufacturing, using and selling purposes.
3. The S-Company and the E-group agree that any result of the research and development performances that are acquired directly or indirectly by the E-group using the know-how shall be exclusive property of the E-Group.

4. This agreement will start on the effective date and will expire x years after the first commercial sale
5. The E-group will pay royalty to the S-Company starting on the effective date. The royalty will be paid over x years for an amount of x SEK per year.

### 3.6.2 Phase out

The S-Company and the E-Group is in agreement regarding the way the royalty will be distributed. One of the aims in the agreement is to license the intangibles to the E-Group who will take on the risk, marketing, distribution of the Product. The E-group will then keep the profit that their contribution to the Product has generated. The E-group will pay royalty to the S-Company for the part of the Product that they have not contributed to. This process will go on for the same number of years as the life expectancy of the intangible property. During that time the profit generated by the E-Group will increase proportionally to the S-Company's decreased royalty and when the life expectancy has come to an end, so has the royalty payment and the intangible property will belong to the E-Group. This procedure is built on the idea that when the life expectancy is finished all the work and investment that the S-Company has contributed with is replaced with the work and investments of the E-Group. The size of the royalty payment is decided by the intangibles life expectancy and estimated value.

This procedure is called a phase out and is commonly used in situations where intangible property is concerned since it is difficult to increase or maintain value in the same way with tangible property. There are of course many different reasons to why two parties would choose a phase out instead of an ordinary transaction.<sup>79</sup> From what I have discovered the one major benefit with a phase out is that that the overtaking company obtain a more regular cash-flow in the sense that there are smaller amounts paid over a number of years instead of one major cost. A more even cash flow is always amiable for an enterprise since it creates more liquidity in the enterprise.<sup>80</sup> The licensor also aims for an even cash-flow and with a phase out they won't have to pay their taxes all at ones. Instead the licensor will pay tax on the royalty they receive each year.

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<sup>79</sup> Interview with Oscar Good, , 2012-03-16

<sup>80</sup> Interview with Jesper Barenfelt, 2012-03-09





# 4 The Reconstruction

The definition of a reconstruction according to the OECD is a "cross-border redeployment by a multinational enterprise of function assets and/or risks".<sup>81</sup> Since the mid- 90's a clear trend where business reconstructions often involve centralisation of intangible property is noted.<sup>82</sup>

Here we can see a situation where the English MNE group is licensing the intangible property from Sweden to England. This is a situation where one enterprise is contributing with a very unique and valuable intangible property, which makes it difficult to find a comparable. To try to define an arm's length price there is a lot of different components to consider. What transfer pricing method is the best one for this particular situation? Should the valuation focus only at the intangible property or the enterprise as a whole? What risks are to consider? How long shall the life expectancy be and how would an independent enterprise reason in this situation? These are complex questions and I will try to answer them with all the guidance and help that I can find. Although the aim here is to come to what you might call the most practical conclusion.

## 4.1 Transfer pricing method

The five different transfer pricing methods presented by the OECD are many times unsatisfactory when it comes to dealing with intangibles. A number of different methods have been developed with the aim of a proper valuation of an enterprise. Most of these methods can be subsumed under three commonly accepted approaches;

1. Cost approach
2. Market approach
3. Income approach.

There are of course other methods/approaches mentioned in the literature but most of them are in fact combinations or variations of the three basic approaches. I will in the following chapters describe their different advantages and limitations when it comes to evaluating intangible property.

<sup>83</sup>

### 4.1.1 The cost approach

The cost approach belongs to the category of the so-called input indicators. In other wording the approach determines the value of the intangible property by the cost of creating and transferring it. This gives that the value of the intangible is the same as the value of its development. Therefore, the

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<sup>81</sup> OECD guidelines 2010 9(1)

<sup>82</sup> OECD guidelines (2010) 9(2)

<sup>83</sup> Boos, Monica, International transfer pricing, The valuation of intangible assets (2003), s 73

higher development cost the higher the value of the intangible property.<sup>84</sup> There are quite many different variations of the cost approach but the most common ones are based on historical costs and replacement costs. The historic cost approach does quite simply calculate the historic costs of developing the intangible and fully relies on the knowledge of cost accountants. Although it is not as easy as it might seem. It would, as an example is very difficult to allocate the historical costs for a well-established trademark like Pepsi or Coca Cola. The replacement cost is based on the cost to exactly reproduce the intangible and are directly estimated on the costs that was necessary in order to create the intangible in the first place. Considerations regarding possible adjustments of the value in order to compensate for technical or economic value decreases must be taken.<sup>85</sup> Generally, the replacement cost approach is used when the data of the historical costs are unsatisfying.<sup>86</sup> The cost approach is seen as relatively weak for evaluating intangible property. One of the major problems is of course that “*Cost is not the same as value*”<sup>87</sup> as far as intangibles are concerned. The value of an intangible is much more related on how much someone is willing to pay for it, simple supply and demand. The R&D costs for the Product in question could be millions and the value could remain zero. If a cost approach is to be used on a transaction concerning an intangible property, the ideal situation would be if the intangible were in the beginning of its life cycle. During that first or second phase, the probability of the R&D cost and the value being the same should be the highest.<sup>88</sup>

## 4.1.2 The Market Approach

The market approach determines value the way that the OECD prefers it, by comparing the intangible to the price that are being paid for similar intangibles in a comparable transaction between independent parties.<sup>89</sup> The comparable analysis demands several steps that can be difficult to meet with an intangible. A search needs to be done for arm’s length transactions, approving the accuracy of the data, selecting relevant units of comparison and making a comparative analysis for each. Besides that, there is the matter of legal rights, financial arrangements, the technological, functional and economical nature of the intangible that must be taken in to consideration.

The first problem with the market approach in this situation is that comparable transactions with intangible rarely exist. The second one is even if a comparable transaction could be found there is a matter of knowing

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<sup>84</sup> Boos, M (2003), s 75

<sup>85</sup> FAR Akademin, IFRS Volymen, RedU 7, Värderingar av tillgångar och skulder vid redovisning av företagsförvärv samt vid prövning av nedskrivningsbehov enligt IFRS. S 27

<sup>86</sup> Boos, M (2003), s 76

<sup>87</sup> Ibid. s 77

<sup>88</sup> Supplement B

<sup>89</sup> Boos, M (2003), s 78

whether the value of the comparable intangible is based on essential data or other values that is based on strategic market considerations. Lastly, intangibles are commonly bundled together in packages with other products and services and it can be very difficult if not impossible to de-bundle the packages and to compare them one by one.<sup>90</sup>

### 4.1.3 The income approach

The income approach estimates value based on the estimated value of what the future economic benefits might generate over the intangibles expected lifetime.<sup>91</sup> To be able to estimate that value the income approach comprises three major components, which are the determination of the future benefits, the choice of the most appropriate valuation method and lastly the calculation of a discount rate or capitalization rate. When valuating an intangible it is important to make sure that the future benefits that are taken in to consideration are directly generated by the intangible.

Concerning the choice of best method, most methods can be divided in to two categories; the capitalization methods and the discount methods. Both of the methods measure the benefits that have arisen directly from the activity of the intangible. The methods in the different categories are fairly similar but they differ in their rate.<sup>92</sup> Even so, the discount rate as well as the capitalization rate ensures that the cash flow in different time periods is comparable. The choice of a discount or capitalization rate is generally based on market data. Both of the rates reflect the risk that is anticipated by the investor, so the higher risk and uncertainty the higher the rate. The rates differ in the sense that the discount rate measures the rate of return that is necessary to compensate the investor for his input of capital whereas the capitalization rate does not account for expected growth. The capitalization rate is used to translate single-period estimates of constant flows of future economic benefits in to one value.<sup>93</sup>

The problems that are connected to the income approach are the estimation of the future economic benefits, the calculation of a discount or capitalization rate and the assessment of the intangibles life expectancy. The future economic benefit estimation may change rapidly if for example the market or industry transform unexpectedly. The build-up of the rates is a procedure that is both subjective and uncertain. The calculations are very complex due to the fact that it does not only involve the analysis of the intangible but also the market and the risk that can vary a lot depending on the assumptions.<sup>94</sup> Finally, the assessment of the life expectancy of a

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<sup>90</sup> Boos, M (2003), s 80

<sup>91</sup> FAR Akademin, IFRS Volymen, RedU 7, Värderingar av tillgångar och skulder vid redovisning av företagsförvärv samt vid prövning av nedskrivningsbehov enligt IFRS. S 27

<sup>92</sup> Boos, M (2003), s 82

<sup>93</sup> Ibid s 84

<sup>94</sup> Ibid. s 87

market intangible is especially difficult. A trademark or a brand name does not have a set life in the way that it will only last for a couple of generations. With that said, a technological intangible usually decrease in value in the end of their cycles as more efficiently technological property are constantly developed.<sup>95</sup>

#### 4.1.3.1 The method of choice

As can be seen of the descriptions of the different approaches, neither the cost method nor the market method is particularly suited for evaluate the Product. The cost approach can be appropriate to use on intangibles if the intangible is a new and un-established intangible hence the value of the input and the value of the intangible is more likely to be the same at that stage. However, the best approach of evaluating unique asset that does not have comparable assets is the income approach and one of the methods under that approach is the discounted cash flow (from now on “DCF”)<sup>96</sup> which is the one that are the most commonly used in these cases.

The fundamental value of a company can be determined by forecasting the future cash flows. The DCF method is an income approach for valuating a company, projects, assets and it is taking into the calculation the time value of money.<sup>97</sup> In other words the DCF methods makes estimations based on risk, estimated future benefits and expected life to determine the present value of the company. The DCF valuation method is based on three steps, 1) create a forecast of near term cash flows, 2) calculate a value of the business over the long term and 3) convert the cash flows and the long term value into their corresponding present value.<sup>98</sup>

The input data that is necessary for the DCF calculation and also the data that is presented in supplement A are the following:

*Sales in the previous year*, this is the base of the forecast of future cash flow. In supplement A the history goes back four years.<sup>99</sup> This is not a standardized number; instead it is based on the stability of the numbers and the character on the market. As an example; if this case was concerning the car market we would have to look further back than four years because that market moves much more in larger cycles and therefore just four years would generate misleading numbers.<sup>100</sup>

Continuing, *the sales growth rate* is another important input data. It is often taken from the historical data and is described in supplement A as percentage of change sales. Clearly speaking it is the expected sales growth. *Cost of goods sold (COGS)* is the third important data and is the inventory

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<sup>95</sup> Boos, M (2003), s 86

<sup>96</sup> Damodoran. A, (2002), s 949

<sup>97</sup> Naveen Kumar, Singh J.P, Hena Uzma Shigufta, Dicounted cash flow and its implication on intangible valuation, Global Business reiew, 2011, 3, 368

<sup>98</sup> Amram, Martha, Value sweep, mapping corporate growth opportunities (2002), s 35

<sup>99</sup> Ibid. s 37

<sup>100</sup> Interview with Asa Ohlsson, 2012-03-30

cost of the goods that have been sold during a specific time period. COGS are the sum of the total cost of producing the product. Another vital calculation is the *Earnings before interest and tax (EBIT)*, *Sales minus COGS*. This is just as its sound a measure of the profit before deducting interests and tax. Finally to complete the bases in the calculation deduct a *tax rate* decided by the tax authorities and other interest expenses.

The numbers of the calculated future cash flows are then summed up and that value are what we call the future cash flow. But in order to give a correct valuation we need to calculate the risk and the life of the intangible. The actual formula for the DCF calculation appears as follow:

$$cfn/(1+r)^n$$

Where the cfn is the cash flow in the last individual year estimated, that is divided by 1 added with the discount rate that represents the risk and then raised up to the number of years that has been used in the future prognoses (in supplement A it is five years). The factor that causes the most problems in this equation is the risk.

#### 4.1.3.2 Risk

When we talk about risk in everyday life we are talking about the chance that something will or will not happened. When we talk about risk from a financial perspective we are more interested in the likelihood that we will receive a return that is different from the return that we are expecting to make.<sup>101</sup> The risk in this transaction is of course of great interest because it decides what chances the parities would have taken in an uncontrolled transaction. To be able to define the risk the first step is to decide if it is a market risk or a firm specific risk. Market risk is basically connected to factors such as exchange rates, interest rates and inflation whereas firm specific risks are factors such as the estimation if a project/product will do better or worse than you expect.<sup>102</sup>

Risk is the degree of certainty (or un-certainty) that the purchaser will realize the expected economic outcome during a specified time. Risks can unfortunately not be observed directly; therefore analysts have developed several different ways to try to estimate the risk based on the available company data.<sup>103</sup>

When using the DCF method the risk in the calculation is represented by the WACC (weighted average cost of capital), which is the cost of financing a company's assets.

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<sup>101</sup> Damodoran. A, (2002), s 60

<sup>102</sup> Ibid. s66

<sup>103</sup> Schweich, Reily, The Handbook of advanced business valuation (2000) s 4

$$E/V \times Re + D/V \times Rd \times (1-Tc) = WACC$$

The WACC calculation is presented in Supplement A with explanations to the abbreviations. What is of the most interest here is the calculation of the cost of equity or as in the example  $Re$ . The cost of equity is the expected return enterprise own capital and is balanced towards the cost of debt ( $Rd$  in the WACC calculation) which is the bank loans that are taken to back-up the investment. Since the trade with intangibles are considered as fairly high risk the cost of equity are normally around 70 percent and the cost of debt around 30 percent in these cases.<sup>104</sup> The higher the risk the higher percentage rate of cost of equity since the banks usually are less enthusiastic regarding loans to high risk affairs. The expected return is based on the risk of the transaction according the following formula referred to as CAPM:

$$Re = Rf + B * MRP + SSP + c$$

$Rf$  here stands for *Risk free rate of return* and are as long as the government is economical stabile usually the effective yield of government bonds. As government bonds are seen as risk free this works as a benchmark for the rate.

$B$  represents *Beta* and is a market risk measure of the company that you are investing in. In this case the industry is medicine supply which gives a beta of around 0.93, which is a beta that is just below medium risk, since medical supply is considered a stabile industry.<sup>105</sup>

$MRP$  represents *Market risk Premium* is the estimated excess rate of the return for equities above the risk free rate of return.

$SSP$  is *Small Stock Premium* which represents the aspect of the company's size. Smaller companies such as the S-Company are considered to be a more high-risk investment than lager companies.

$c$  represents *country risk premium* but is not applied in this case. This premium is almost only used when the transaction concern non-western countries. Alternatively, western countries with a very low credit rate.<sup>106</sup>

The different asset classes in the WACC are weighted as a percentage of the company's total asset base. The cost of financing is the minimum rate of return that investors require of an investment. If an investment is exclusively financed with equity, the WACC will be the required rate of return of the equity investor. The WACC is used when discounting cash flows to make sure that an investment meets the required rate of return of an

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<sup>104</sup> Supplement A

<sup>105</sup> Supplement C

<sup>106</sup> Koller Tim, Goedhart Marc, Wessles David. Measuring and managing the value of companies (2010). s 238

investor/purchaser. If WACC is used in a DCF analysis as the discount rate and the DCF turns out negative the investment should be rejected. With a decreased WACC the valuated firms estimated value increases.<sup>107</sup> In this case the calculated risk is estimated to 13,67 percent.<sup>108</sup> This can be seen as a medium-high WACC since the average in similar cases lies between 10 and 15 percent. If the data necessary for the WACC calculation is unavailable it is not uncommon to choose two or more different percentage rates, calculate the same formula with each on and then based on the risk attached to the company determine which WACC that is the best guess.<sup>109</sup> The market of medicine is a market under constant development and it generates a lot of new products. This causes a certain amount of uncertainty since the possibility of a new better product always is lingering. A factor that can stabilize the risk is a stabile trademark and a genuine R&D that will make the product more protected against new similar products and also creates new products that can be marketed under the trademark.

In the additional stage the life expectancy is added to the calculation. I have in supplement A calculated for an unlimited life expectancy, which gives a formula as follow:

$$(cfn \times (1 + g)) / r - g$$

Where the cfn represents the same as previously mentioned, multiplied with 1 added to g that represents the long-term growth rate and then divided by the discount rate minus the long-term growth rate. The result is the future cash flow with unlimited life expectancy the so-called perpetuity value. The key factor here is how to determine the life expectancy.

#### 4.1.3.3 Life expectancy

The expected life of an asset represents the time period that the asset will generate a profit.<sup>110</sup> Intangible property is valued in different ways depending on whether they are created internally or if they are acquired.<sup>111</sup>

One opinion is that intangible property in general is known to have a quite short life expectancy. To be more precise, the life expectancy is normally as long as its legal life expectancy but often shorter.<sup>112</sup> This to me sounds more like an indication of the massive quantity of R&D that are generating intangible property to the point where there are many un-established intangibles on the market, rather than a valid rule of thumb to follow in cases such as this one. In addition, as being suggested a new, un-established

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<sup>107</sup> Naveen Kumar, Singh J.P, Hena Uzma Shigufta, Dicounted cash flow and its implication on intangible valuation, Global Business review, 2011, 317

<sup>108</sup> Supplement A

<sup>109</sup> Interview with Oscar Good, 2012-04-13, kl13:00

<sup>110</sup> Flingnor Paul, Orozco David, s 9

<sup>111</sup> Damodaran. A, Investment Valuation (2002), s 33

<sup>112</sup> Flingnor Paul, Orozco David, , s 9

intangible will have a short life expectancy but then again a well-established intangible can have a very long, even unlimited life expectancy.<sup>113</sup>

It is extremely difficult to calculate the life expectancy of an intangible property. In this case 98,5 percent of the enterprise turnover is based on the Product. Looking at the license agreement it is clear that the parties involved sees this as a transaction of intangible property only. However, the additional 1,5 percent is founded merely on freight and cannot be transferred and any result of the results from the R&D that are acquired by the E-group using the know-how shall be exclusive property of the E-Group. Those factors give me the impression that the license agreement is really a transaction of a fully-fledged enterprise and should therefore be valued as such. The difference between evaluating the intangible property by itself or to see this transaction as a sale of a fully-fledged company lies in the different ways the life expectancy is determined.

The Product being valued as an intangible might have a life expectancy for about 10 years. This is due to the fact that the Product is very well established, and has a strong brand name. Together with stabile numbers and a relatively high turnover generated mainly by the Product, gives a relative long life expectancy.<sup>114</sup> Although, as can be seen in Supplement A, I am of the opinion that the transaction should be seen as transaction of a fully-fledged company and should therefore have an unlimited life expectancy. The argument for unlimited life is that with a well-established trademark, the know-how and a well-functioned R&D there is a good possibility that the company can keep on a successful development of the intangible and other products that can be used to prolong the life of the intangible property.

However, in the end, what we really want to know is what the company is worth today and not in the future. This formula that gives the present value of perpetuity value:

$$PV/(1+r)^n$$

Here the PV stands for perpetuity value that is divided by 1 added with the discount rate and then raised up to the number of years that has been used in the future prognoses. The result of the final formula is what I have estimated the S Company to be worth today.

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<sup>113</sup> Interview with Oscar Good, 2012-04-12

<sup>114</sup> Interview with Oscar Good, 2012-05-07



## 4.2 Arms length price analysis

The arm's length price is as previously mentioned the price that would be agreed on by two parties in a comparable uncontrolled transaction. However, in this situation there is no such comparable transaction. The intangible property in question that is up for analysis is so unique it will not be possible to find an existing reliable uncontrolled transaction. Instead, the analysis of this transaction will be compared with a hypothetical comparable controlled transaction.

Most of the arm's length analysis is made along with the valuation. The risk calculations are made based on what is reasonable in this particular situation. Factors such as market risk, company risk, the size of the enterprise and the profitable nature of the intangible are all included in the WACC calculation. This is factors that I believe unrelated parties would include as this is how investors/purchasers would value an enterprise in order to decide if it was a good idea to invest. The same consideration is done regarding the life expectancy, the odds and chances for new improved products in this industry are considered as well as the somewhat insecure nature of intangible property in general, the nature of the Product in particular and an analysis of the terms and conditions in the agreement. In the end my opinion is that even if the agreement is made out to be concerning the intangible property only this transaction is in fact a fully-fledged reconstruction and that independent parties in the same situation would come to the same conclusion.

Since the life expectancy for a fully-fledged transaction of this nature is unlimited, it will be very difficult if not impossible to obtain the phase out requests in the agreement. Even if the unlimited life expectancy actually has an end because of the WACC that decreases the cash flow, it would be a matter of almost 20 years. It would be a very uncommon and uncertain procedure to decide the number of years for a phase out. In addition, the procedure to establish the amount that should be paid each year would be to divide the result of the DCF calculation on the decided number of years. How much of percentage of the actual profit generated by the intangible property would then be decided by that amount. There is a great possibility that the percentage rate would reach over 100 percent most of those years.<sup>115</sup>

My opinion is therefore that parties in an uncontrolled transaction would see this as a fully-fledged reconstruction with a medium high risk and that a phase out in this situation would not be to recommend. The recommendation would be to change the phase out conditions in the agreement, decide for a value of 785 million SEK<sup>116</sup> that should be paid either on the day of the transfer of the intangible property or if they wish during x number of years but seen as pay of debt and not a phase out. This

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<sup>115</sup> Interview with Oscar Good, 2012-05-07

<sup>116</sup> Supplement A

would generate the agreement changing from a license phase out agreement to a much more ordinary purchase agreement.

## 5 Analysis

One of the aims with the essay is that it should have different layers depending on which angle you took when you observed it. One angle is from a social science point of view, an example of in what direction and what speed the society is evolving. 15 years ago I probably would not be writing this essay because the problem with intangible property in controlled transactions was not this big of an issue at the time. Intangible property is a major part of the world trade today and the content of this essay is evidence that neither the guidelines nor the Swedish legal system is up to speed. In other words the legal theory and practical line of action concerning this subject is very far from each other which is what can happen in a society that evolves with such haste that the regulatory system cannot keep up.

The other more central angle is from a juridical point of view. To show the reader how inadequate the only available guidelines and rules actually are. This inadequacy creates a lot of uncertainty in an important and growing area. What has happened is that the juridical sector has been pushed away in favour of the economic sector. Transfer pricing is of course a subject that needs its fair share of math and formulas but without any guidance it can easily be too arbitrary and creates a lot of work, uncertainty and additional costs for both the private sector and the tax authorities. Later in the conclusion I will show what I think is needed concerning the guidelines in order for them to better meet the demand of guidance in these situations.

There are not much help to get neither from the OECD or Swedish law in this situation. One could argue that the description and explanation of the arm's length principle together with the suggestion to try to include a market evaluation when calculating the risk are what can be taken from the OECD guidelines in this situation. Some of the factors mentioned in the guidelines concerning function analysis are used in the analysis of the S Company. Instead of a comparable transaction the focus lies on estimation of risk and expected life and comparison is made in the end of the calculation with a hypothetical enterprise. Even a short evaluation of some of the factors that needs to be taken in to account in order to establish an arm's length price in this situation shows the difficulty of applying the arm's length principle in today's sophisticated economical environment.<sup>117</sup>

Regarding the Swedish regulations, it is easy to say there is not much to lean on. The correction rule has a clear status of *lex specialis* and it is also clear on what it wants to accomplish in the matter of removing unfair price advantages for associated enterprises. The most important functions of the Swedish regulations is the definition of intangible property, the definition of an associated enterprise and the function as a gateway to the OECD

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<sup>117</sup>Markham, M (2005), s 28

guidelines. However, Swedish regulations do not give any guidance on how to establish if the prerequisite that are drawn up in 14 chapter 19§ IL in order to define an unfair price setting are fulfilled or not.

How is one to know if the result of an enterprise is decreased as a result of terms and conditions that has been arranged between enterprises that would not have been between independent parties? Through the Shell case we are sent back for guidance to the OECD guidelines. Swedish rules and cases are really not useful until the point that you find yourself in court.

With that being said it is worth mentioning that this is a very difficult area to regulate. The combination of law and economics is a complex one and economy is a lot about qualified guesses, which can be hard to combine with the legal system. In addition, international guidelines will always be in the position that they have to be very openly drawn to the point that as many of the alleged nations can accept the guidelines or treaty but still not so vague that it is losing its purpose.

## 5.1 Comparability

The methods that the OECD prefer is closely connected to how well they compare the controlled transaction to a uncontrolled transaction, which seems to be the golden way to an arm's length price according to the guidelines. The problem here is of course that it is quite impossible to find a suitable comparable transaction. Many of the comparability factors that are attended to in the guidelines are not use in this case. The practical comparability issue is in the practical approach replaced by a hypothetical one in combination with the problems regarding risk and life expectancy.

In this case, the risk (or WACC) it is extremely difficult to determine whether it is concerning the entire enterprise or the rights to the Product. Even if the OECD has given us some additional guidance when it comes to intangibles it is not enough and the determination is very complex. The problem with life expectancy is that it is just briefly mentioned in the guidelines since none of their transfer pricing methods has to take that aspect in to consideration. The life expectancy of an intangible is an issue that are in need of a lot of focus but is receiving so little of it at present date. None of the highly regarded authors that I have been reading in my chase for enlightenment in this question wants to give more than to establish that it is a difficult matter to decide.

The problem that lies ahead after established the risk and the life expectancy is the matter of deciding if hypothetical parties in an uncontrolled transaction would have agreed on the same terms and conditions as the ones in the transaction in question. This is not an easy question. There are badly done transactions being done on daily basis so even an unusual price in any direction could be an arm's length price. Hypnotically, even if an independent party never have purchased a product just like the Product for a price of 785 million SEK does not mean that it is not an arm's length price.

There are not any guidance concerning this problem at the moment and we have to rely on more or less qualified guesses.

## 5.2 Transfer pricing methods

If I would try to only use the legal framework that are available today concerning transfer pricing methods in an attempt to establish a reasonable arm's length price for this transaction I would give myself a difficult task. The theoretic guidance accessible is quite far from what I will refer to as the "practical approach".

The guidelines have the five accepted methods that are rated in importance depending on how direct it generates an arm's length price. Even if the profit split method is mentioned as being a good choice regarding intangible property it is not the most ideal method when it comes to only one party that are contributing with a valuable unique intangible property.

The practical approaches are not perfect. Moreover, as it is not regulated it is difficult to know which factors to focus on for the best choice in different situations. The lack of guidance also gives a lot of room for subjectivity and arbitrary decisions. The income approach regarding this kind of transaction from an economical perspective is an obvious solution, choosing the form of DCF that I did is more a matter of what feels right. There are a number of methods based on discounted cash flow with minor differences. My choice was based on the information that it is a very commonly used method in these situations in combination with DCF being fairly simple and straightforward.<sup>118</sup>

In the end, it is all about finding the method to establish the best arm's length price. If I had followed the guidelines, the result would have been a lot more difficult to get to and further away from the correct price.

## 5.3 Guidance

What would in fact be helpful are suggestions of which transfer pricing method that is the best one when we are dealing with intangibles. Guidance concerning the risk and life expectancy would also be preferred even though it would be more difficult to write guidelines or rules in that area. However, even very universal guidance is better than no guidance at all and I believe that in general the enterprises and the tax authorities strive towards the same goals, which is to make the most accurate valuation and by that make the best estimation of the arm's length price. Many of the problems that occur are coming from lack of guidance, knowledge, and not a will to try to avoid taxes.

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<sup>118</sup> Interview with Oscar Good, 2012-03-16, kl 9:30

## 6 De lege ferenda

There is, from what I have discovered, in general usually a gap between theory and practise. In general things do simply not work exactly (or sometimes even close) to what the books says. However, even if that is the situation, juridical norms and other sources of guidance can still be very helpful guiding you in the right direction, giving you hints on where to focus and what to ignore. The subject of determining an arm's length price for intangible property and by that trying to evaluate that property is a subject where the theory is so far from the practical it has almost become useless.

The trade with intangible property has increased massively during the past years and it is time for an update. The most natural evolvement would be for the OECD to renovate their guidelines, more than trying to change the Swedish laws since this is a matter on international ground. The guidelines needs to be more considerate towards intangible property and I am sure that even if updated guidelines this subject will not be an easy one but it will provide better guidance that will create more security both to the enterprises and the tax authorities.

### 6.1 Definition

First of all the definition of an intangible should be clearer. Since the OECD definition should assist the domestic laws a more comprehensive description would help finding consensus on an international level and by that help avoiding double taxation. Instead of a line-up of what the term intangible property include it would be more helpful with a general definition that states that the term intangible is intended to focus on things that is not a physical asset or financial asset but that it is capable of being owned or controlled in order to produce a value. It is also important to point out that the main consideration is if a transaction of an intangible generates economic value from one related enterprise to another irrespective if that value comes from tangible property, services or intangible property. I would also like to include that if a kind of property or service is not included specifically in the guidelines it does not imply that that property or service does not need to be considered when determining an arm's length price.

A more detailed description of the different classes of intangible property would also be preferred. Even if there are descriptions in Swedish law that provides guidance in this matter it would be helpful with international guidelines. The class of intangible property that needs the most attendance is the ones that has the strongest connection to economics and is therefore unregulated in Swedish law. The main groups within this classification are know-how, trade secrets and goodwill.

Know-how and trade secrets could loosely be described as information or knowledge that assist or improves a business but is not registered for protection. Both know-how and trade secrets usually consists of concealed information concerning industrial or commercial substances. On the same subject, Goodwill could be defined in many different ways. It can be the difference between the total value of the business and the value of all separately tangible and intangible assets. It can also be the future economic benefits that are related to assets that are not identified individually.<sup>119</sup> Goodwill is because of its many different meanings difficult term to describe but to account for the most common descriptions in general wording could be a good guideline.

## 6.2 Comparability

The comparability analysis for intangible property as it exists today is not very helpful. Instead of the comparability factors that are of service in the present chapter one, three and six in the guidelines it would be much more helpful with guidance that encourage to a process where the perspectives of both parties are taken in to consideration and the options that are realistically available for those parties.

As an example, from the transferor's perspective the way to determine an arm's length price by examining the price, which a comparable independent enterprise would accept in order to transfer the intangible property or the rights to the intangible property. From the transferees perspective it would be interesting to evaluate if that price is of an arm's length character by research if the price is properly based on the potential value and usefulness of the intangible property in that business.

Special consideration to whether or not the right to the intangible I exclusive or not should be considered since it many times gives the receiving party an important market benefit. It is also important to clarify that since intangibles so many times have unique qualities their possibility to create a future value can differ a lot. It is therefore important to include the consequences related to the unique qualities in the function analysis.

The factor of life expectancy is an urgent matter to attend to. It needs to be mentioned that it is important to consider the life expectancy of intangible property and that an intangible with a longer life expectancy will be more valuable than an intangible with short life expectancy. Even if it would be problematic to provide guidelines that are too specific it should be mentioned and discussed as a part of the analysis. What can be interesting is what factors are and how they might affect the life expectancy. For example, it should be noted that the life expectancy could be affected by the nature

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<sup>119</sup> Robinson R. Thomas, van Geuning Hennie, Henry Elaine, Broihahn A. Michel, International financial statement analysis (2009) s 331

and life expectancy of its legal protection. One of the key variables should be the affect by new and improved products.

Another factor that is so important that it is worth mentioning is the consideration of the stage of development of the intangible, to reflect on whether or not the intangible is well established or not. Moreover, if the intangible property in question is not fully developed and more investments for R&D is needed that should be considered in the analysis since a more well established intangible often is more valuable.

Lastly, the risk factor should be included in the analysis. The fact that the risk is related to the probability of the possible future economic profit from the intangibles should be noted. All the risks related to the future value of the intangible should also be considered as well as risks that are related to the products ageing and reduction of the value of the intangible and the risks related to the products liability.

### **6.3 Transfer pricing methods**

One of the main issues with valuating intangible property is the difficulty of identifying comparable uncontrolled transaction. The five transfer pricing methods that the OECD guidelines provide today are not ideal to apply in cases with intangible property and that some of them should be used with care determining the arm's length price for intangibles. There is a need for approved methods that are more suitable for these situations.

To begin, a piece should be dedicated to a solution to situations where reliable comparable uncontrolled transactions do not exist. If a comparable uncontrolled transaction cannot be identified the focus should shift to determine a price that unrelated parties would agree on during comparable conditions. Factors that should be important to consider are the risk, the assets and the reason and why the parties are interested in the transaction. In order to be helped by these factors there need to be an established price set for the transaction.

At the moment, the profit split method is the best OECD approved method for intangibles. The profit split method does require some sort of joint custody of the intangible in order for the method to be useful and that is of course not always the case. First of all it should be established that other methods that is not bound to identify a comparable uncontrolled transaction are allowed to be used under the right circumstances. Secondly, economic valuation methods should be mentioned and specifically methods that estimate discounted value of future cash flows. There are a number of different methods that uses DCF as base and the same concerns should be considered for all of them. It should be noted that the reliability of the economic valuation methods is in many aspects grounded in the assumptions and estimations you need to make in these cases and that it is highly speculative.



Furthermore, the discount rate or the WACC should be mentioned. Maybe not how it is determined but what purpose it serves. That the discount rate is the time value of money and that it symbolizes the risk of the transaction. In addition it is very important that attention is given to the estimations that the discount rate is based on.

The issues with determining life expectancy should also be mentioned here. The life expectancy is a key variable to determine a future cash flow. The fact that the expected life can be affected by its possible legal protection as well as scientific changes in the specific industry should be included. It should be recognised that intangibles in some situations where for example a trademark can be recycled by serving new products, might have eternal life.

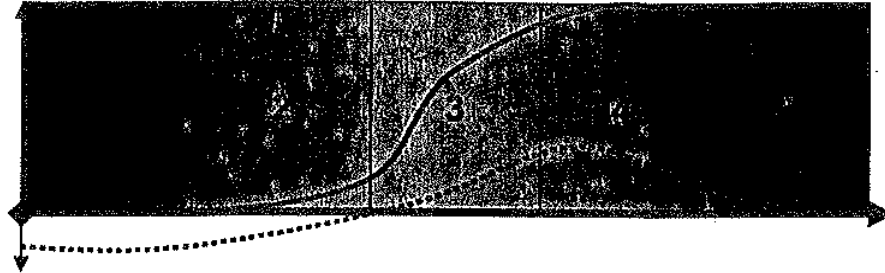
I would not say that the valuation of intangible property will be easy if more guidance as written in the conclusion existed. Although, my believe is if guidelines that are more suited for intangible property were available a cross-border consensus would be closer in reach. More appropriate and helpful guidelines would work well as a contribution the financial ideas that currently are deciding the benchmarks for this area. Most important, it would be a step in the right direction towards a more consistent and homogeny arm's length price.

# Supplement A

	2006/2007	2007/2008	2008/2009	2009/2010	4 år	Snitt 4 år	2010/2011	2011/2012	2012/2013	2013/2014	2013/2014		
Sales	103436.00	101114.00	134166.00	125635.00	464351.00	116087.75	131917.00	138513.00	145438.00	152710.00	160345.50		
COGS	44068.00	35987.00	46506.00	57653.00	184214.00	46053.50	60536.00	63563.00	67440.00	70077.00	73580.85	Tax	28% 2006-2009
EBIT	59368.00	65127.00	87660.00	67982.00	280137.00	70034.25	71381.00	74950.00	78698.00	82633.00	86764.65	Tax	26.30% 2010-
Schabonskatt	16623.04	18235.96	24544.80	17879.27	77282.67	19320.67	18773.20	19711.85	20697.57	21732.48	22819.10		
Cash flow	42744.96	46891.44	63115.20	50102.73	202854.33	50713.58	52607.80	55238.15	58000.43	60900.52	63945.55		
% Change sales		-2.24%	32.69%	-6.36%	24.08%	8.03%	5.00%	5.00%	5.00%	5.00%	5.00%		
DCF	Cf						46281.16	42751.11	39490.59	36478.55	33696.21	198697.62	
					Present value of perpetuity value								
			Perpetuity value										
			1489868.72		785088.66								
WACC	$E/V \times Re + D/V \times Rd \times (1-Tc)$		$CFN \times (1+0.025)^t / 0.1367 - 0.025$										
Re	Cost of equity		Ev	70%	WACC Example								
Rd	Cost of debt		Dv	30%	70%	17%	30%	8%	73.70%	13.67%			
V	E+D		Re	17%					(1-26.3) S				
E/V	Percentage of financing that is equity		Rd	8%									
D/V	Percentage of financing that is debt												
Tc	Corporate tax rate		Tc	26.30%									
DCF	$CFN / (1+r)^n$		$FV = PV \times (1+r)^N$	1									
Cfn	198697.62		320004.500										
r	13.67%												
n	5												

# Supplement B

## Product life cycle



1. Development. No sales, only costs.
2. Introduction. Small growth. Losses. Large marketing/introduction costs.
3. Growth. Quick market acceptance and improved profit.
4. Maturity. No more growth. Profit is stable or decreases due to new products at market. Can expand this period with improvements of product or package deals.
5. Decline. Sales and profit decreases.

# Supplement C

Data Used: Value Line database, of 5928 firms

Date of Analysis: Data used is as of January 2011

Industry Name	Number of Firms	Average Beta	Market D/E Ratio	Tax Rate	Unlevered Beta	Cash/Firm Value	Unlevered Beta corrected for cash
Advertising	28	1.79	36.55%	12.86%	1.36	11.96%	1.55
Aerospace/Defense	63	1.15	23.64%	21.10%	0.97	9.62%	1.07
Air Transport	40	1.21	52.64%	22.30%	0.86	9.70%	0.95
Apparel	48	1.35	15.80%	20.86%	1.20	9.14%	1.32
Auto Parts	47	1.78	24.67%	13.45%	1.46	7.28%	1.58
Automotive	19	1.50	108.58%	20.43%	0.80	13.18%	0.93
Bank	418	0.75	85.86%	13.89%	0.43	8.29%	0.47
Bank (Canadian)	7	0.86	13.77%	20.27%	0.78	7.10%	0.84
Bank (Midwest)	40	0.96	69.03%	18.02%	0.61	9.49%	0.68
Beverage	34	0.92	13.09%	19.08%	0.83	3.69%	0.86
Biotechnology	120	1.13	13.24%	5.74%	1.01	16.31%	1.20
Building Materials	47	1.33	71.38%	11.69%	0.82	6.90%	0.88
Cable TV	24	1.43	68.40%	22.98%	0.94	3.35%	0.97
Canadian Energy	10	1.14	28.44%	10.36%	0.91	3.24%	0.94
Chemical (Basic)	17	1.28	18.75%	22.39%	1.12	5.41%	1.19
Chemical (Diversified)	31	1.51	21.07%	23.87%	1.30	6.22%	1.39
Chemical (Specialty)	83	1.37	23.06%	14.85%	1.14	4.22%	1.20
Coal	25	1.59	16.16%	13.17%	1.39	3.74%	1.45
Computer Software/Svcs	247	1.06	4.68%	13.88%	1.02	9.48%	1.12
Computers/Peripherals	101	1.27	9.13%	8.94%	1.18	10.45%	1.31
Diversified Co.	111	1.22	99.77%	17.14%	0.67	11.99%	0.76
Drug	301	1.11	14.10%	6.72%	0.98	8.96%	1.08
E-Commerce	52	1.14	4.58%	17.19%	1.10	8.09%	1.19
Educational Services	37	0.79	8.89%	27.32%	0.75	11.26%	0.84
Electric Util. (Central)	23	0.78	96.84%	25.40%	0.45	2.35%	0.46
Electric Utility (East)	25	0.73	74.73%	30.56%	0.48	2.26%	0.49
Electric Utility (West)	14	0.75	83.18%	31.47%	0.48	2.60%	0.49
Electrical Equipment	79	1.32	10.91%	15.54%	1.21	6.61%	1.29
Electronics	158	1.13	18.40%	12.85%	0.97	14.08%	1.13
Engineering & Const	17	1.65	7.93%	28.52%	1.56	15.56%	1.85
Entertainment	75	1.72	37.99%	14.68%	1.30	5.92%	1.38
Entertainment Tech	31	1.39	7.80%	7.49%	1.29	16.71%	1.55
Environmental	69	0.85	41.13%	11.02%	0.62	2.50%	0.64
Financial Svcs. (Div.)	230	1.37	135.83%	18.63%	0.65	13.43%	0.75
Food Processing	109	0.87	28.98%	21.80%	0.71	3.91%	0.74
Foreign Electronics	9	1.14	29.55%	30.06%	0.94	23.30%	1.23
Funeral Services	5	1.22	50.78%	29.02%	0.90	4.27%	0.94
Furn/Home Furnishings	30	1.67	26.18%	16.87%	1.37	8.32%	1.49
Healthcare Information	26	0.94	4.86%	22.42%	0.91	5.67%	0.96
Heavy Truck/Equip Makers	8	1.94	46.41%	19.97%	1.42	8.90%	1.55
Homebuilding	24	1.39	89.05%	6.07%	0.76	27.68%	1.05
Hotel/Gaming	52	1.76	49.08%	15.93%	1.25	6.15%	1.33
Household Products	22	1.17	18.38%	27.46%	1.03	2.14%	1.05
Human Resources	24	1.44	9.14%	23.73%	1.35	14.23%	1.57
Industrial Services	137	0.96	26.26%	20.50%	0.79	7.97%	0.86
Information Services	26	1.10	20.21%	22.44%	0.95	3.28%	0.98
Insurance (Life)	31	1.39	18.28%	20.29%	1.21	15.97%	1.44
Insurance (Prop/Cas.)	67	0.92	11.12%	19.50%	0.85	10.27%	0.94
Internet	180	1.11	1.57%	7.89%	1.09	9.48%	1.21
Machinery	114	1.22	28.52%	19.61%	0.99	5.82%	1.05
Maritime	53	1.37	138.71%	6.54%	0.60	6.88%	0.64
Medical Services	139	0.88	38.70%	20.56%	0.67	15.24%	0.80
Medical Supplies	231	1.02	11.48%	13.12%	0.93	7.65%	1.01
Metal Fabricating	30	1.44	18.24%	22.51%	1.26	12.60%	1.44
Metals & Mining (Div.)	69	1.33	11.01%	7.07%	1.21	3.32%	1.25
Natural Gas (Div.)	32	1.25	34.98%	15.07%	0.97	2.08%	0.99

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