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HIGHLIGHTS

Auditors to Enforce Sharing of Stock Option Costs for 1996, Later Years
The Internal Revenue Service no longer insists that taxpayers include stock option costs in cost sharing agreements with foreign affiliates for years before 1996, but auditors will continue to enforce the sharing of those costs for later years, which fall under revised cost sharing rules, the IRS says in its first industry directive issued in the transfer pricing area. **Page 795; Text, Page 810**

Foley Addresses Competent Authority's Role in APAs, Revenue Procedure
Advance Pricing Agreement Program Director Sean Foley disputes the view that the U.S. Competent Authority should be less involved in the APA process. . . . Separately, Foley says the revision of the APA revenue procedure, expected this summer, will address mainly procedural matters. **Page 796**

Review Panel Upholds Transfer Pricing Penalties in 11 of 11 Cases
The IRS's Transfer Pricing Penalty Oversight Committee recommended penalties be upheld in 11 of 11 cases in which they were imposed. In the cases—covering 1996 and subsequent years—failure to turn over documentation precluded the IRS from waiving the penalties, an official says. **Page 797**

Two FSAs Urge §482 Approach; Third Postpones Decision Where No Abuse
The IRS National Office advises examiners to pursue Section 482 arguments in field service advice issued in two cases involving Section 351 nonrecognition transactions, but postpones addressing the Section 482 argument in a case where it says the partnership form was not interposed to create the alleged abuse. **Page 797; Page 798; Page 800**

ANALYSIS

Accounting for Margin and Volume Effects of Intangibles Under CPM
The comparable profits method may provide the tested party with more than a routine profit for intangibles, according to Brian Becker of Precision Economics LLC in Washington, D.C. However, he explains, the increases in volume may cause the tested party's absolute profit to exceed the profits expected of an entity that does not own the intangible. **Page 831**

PERSPECTIVE

German Transfer Pricing on the Move: Legislation, Guidance
While Germany's transfer pricing provisions have not changed in 19 years, policies have been far from stagnant, say Heinz-Klaus Kroppen, Stephan Rasch, and Achim Roeder of Deloitte & Touche in Düsseldorf. They describe the status of transfer pricing legislation, the impact of recent German court decisions, and prospects for additional guidance. **Page 835**

ALSO IN THE NEWS

GERMANY: Germany plans to issue a draft circular this spring on the transfer of functions and risks within a group of related parties, which would cover transfers of manufacturing activities, distribution functions, and service operations outside the country. **Page 806**

LITIGATION: Imaging equipment manufacturer Eastman Kodak Co. sues to recover $15.6 million in tax payments resulting from Section 482 allocations for intangible royalty income imputed to it from its Spanish and Brazilian subsidiaries. **Page 801**

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Analysis

Comparable Profits Method: Accounting for Margin and Volume Effects of Intangibles

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The comparable profits method (CPM) used in the United States and similar methods used overseas (*e.g.*, the transactional net margin method)[1] in the transfer of intangible property may have the effect of providing the tested party with more than a routine profit level, *i.e.*, non-intangible owning profit level. That is, the CPM provides the tested party with a *margin* that is consistent with not owning a valuable intangible. However, the absolute profit earned by the tested party may far exceed the profits expected of a non-intangible-owning entity due to the increases in volume.[2]

Effect of Intangibles

Valuable intangible property benefits licensees in a number of ways. It can increase the licensee's profit margin by reducing its production or manufacturing costs or by increasing the price at which the licensee sells the product. The intangible often *increases the volume of sales* enjoyed by the licensee as well.[3]

Both the profit margin effect and the volume effect can be significant, and most intangible property offers both a margin and a volume effect. Certain intangibles offer more of a margin effect, while the effect of other intangibles is generally seen on the volume level. Pharmaceuticals sold with valuable patents and brand names often sell for up to 10 times more than generic versions of the same drug, leading to much higher profit margins.[4] Pharmaceutical brand names also have a volume effect, but generic manufacturers have increased their volumes (market shares) significantly in recent years.[5] Similar profit margin-dominating effects can be seen in high-end apparel (*e.g.*, Gucci, Coach, etc.) where non-branded products make up a large market share by volume, but the branded products sell for significant price premiums.

The primary value for intangible property in many industries is volume instead of profit margin (price). Coca-Cola, Pepsi, and Dr. Pepper/Seven-Up sell at prices that are of the same order or magnitude as generic cola products. However, the volume effects of the brand names held by these companies are tremendous. The three companies constitute a 90.2 percent share of the U.S. soft drink market, with no other company above 3.3 percent.[6] Similarly, fast food outlets operating under established brand names sell their products at prices similar to those of their nonbranded competitors. But the brands have a significant volume effect as measured in market share:

- McDonald's, Burger King, and Wendy's constitute a 75 percent share of all chain fast-food hamburgers, with another 10 percent made up by Hardee's and Jack-in-the-Box.[7]
- Kentucky Fried Chicken had approximately 55 percent of all quick-service chicken sales in the United States (1999), more than seven times the market share of the next largest competitor.[8]

These examples show that valuable intangibles can benefit licensees in different ways, which may affect the estimation of an arm's-length royalty rate.

Payment for Intangibles Under Standard CPM

As one of the more common transfer pricing methods for the licensing of intangible property, CPM focuses on the profit rate of the licensee compared to similar firms with no valuable intangible property. As such, the CPM generally forces the licensee to pay for the gains provided by the licensed intangible in its margins, but not in its volume. That is, the CPM determines an arm's-length profit margin for a similar operation without intangible property (routine), and sets the royalty as the difference between the actual profit margin

[1] The term "CPM" will be used to include the CPM, transactional net margin method (TNMM), and any other similar profitability method.

[2] "Volume" in this article simply refers to size and does not consider the effect of market power. Market power is another important, related concept. *See* Olson, Lawrence, "Misconceptions Regarding Volume and Size in Transfer Pricing" (5 *Transfer Pricing Report* 73, 6/05/96).

[3] This concept of volume affecting royalty rates in licensing is described in Malki, Elli, "The Economic Sense of Royalty Rates," *Social Science Research Network Working Paper Series* 1997, Aug. 6, 1997.

[4] Standard & Poor's Industry Surveys, "Health Care: Pharmaceuticals," Dec. 27, 2001.

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[5] Generic market shares increased from 19 percent in 1984 to 47 percent in 2000. *PhRMA Annual Survey 2001*, Chapter 5.

[6] See www.beverage-digest.com/editorial/010215s.php.

[7] Nonchain fast food sales are modest by comparison. See www.activemedia-guide.com/hamburg_mrkt.htm.

[8] See www.kfc.com/about/facts.htm.

and the routine profit margin.[9] The routine profits from the benchmark companies do not measure routine *volumes*, only routine profit margins.

For intangibles that provide value at the profit margin level primarily (instead of volume), such an approach forces the licensee to pay most of its nonroutine profit back to the licensor. In the first example below, the intangible property provides value by allowing the licensee to increase its product price.

Table 1: Profit Calculation Under CPM for an Intangible that Allows Licensee to Increase Its Price

Financial Item	Licensee without Intangible	Licensee with Intangible
Net Sales	200	300
Cost of Goods Sold	150	150
Gross Profit	50	150
Operating Expenses	40	40
Operating Profit	10	110
Operating Profit Margin	5 percent	36.7 percent
Routine Operating Margin		5 percent
Royalty Rate		31.7 percent
Royalty		95
Profit Remaining with Licensee		15
Intangible Profit Kept by Licensee		**5**

Thus, using an operating margin as the profit level indicator (PLI), *most* (95 percent)[10] of the intangible profit is sent to the licensor when the intangible increases the price charged by the licensee.

Similar results are seen when the intangible allows the licensee to reduce its unit costs.[11]

Table 2: Profit Calculation Under CPM for an Intangible that Allows Licensee to Decrease Its Costs

Financial Item	Licensee without Intangible	Licensee with Intangible
Net Sales	200	200
Cost of Goods Sold	150	100
Gross Profit	50	100
Operating Expenses	40	40
Operating Profit	10	60
Operating Profit Margin	5 percent	30 percent
Routine Operating Margin		5 percent
Royalty Rate		25 percent
Royalty		50
Profit Remaining with Licensee		10
Intangible Profit Kept by Licensee		**0**

With the operating margin as the PLI, *all* of the intangible profit is sent to the licensor when the intangible decreases the cost structure of the licensee. The slight difference in these two examples is caused by the choice of PLI—the opposite effect would occur if operating profit/total costs were the chosen PLI.[12]

While these examples demonstrate that most or all of the intangible-increased margin will be received by the licensor, the same cannot be said for the increased volume to the licensee. Rather, increased volume (all else being equal) increases the routine profit *levels* proportionately without increasing the profit margin. Such an intangible would keep the licensee at the same profit margin level as similar companies without valuable intangible property. As seen in the example below, the licensor receives no royalty under this type of CPM when the effect to the licensee is only at the *volume* level.[13]

Table 3: Profit Calculation Under CPM for an Intangible that Allows Licensee to Increase Its Volume

Financial Item	Licensee without Intangible	Licensee with Intangible
Net Sales	200	600
Cost of Goods Sold	150	450
Gross Profit	50	150
Operating Expenses	40	120
Operating Profit	10	30
Operating Profit Margin	5 percent	5 percent
Routine Operating Margin		5 percent
Royalty Rate		0 percent
Royalty		0[14]
Profit Remaining with Licensee		30
Intangible Profit Kept by Licensee		**20**

Thus, all of the volume benefits accrue to the licensee, as the licensee's profits increase (triple) at the same rate as the value increases.

The choice of PLI can have a significant impact on the resulting transfer prices.[15] The CPM analyses above do not incorporate the volume effects of intangibles because the PLIs focus on the income statement; however, this is not true for PLIs using the balance sheet (*e.g.*, re-

[9] Residual profit splits also use the concept of a routine profit, and the routine portion of the residual profit split analysis is typically applied like a CPM analysis.

[10] Intangible profits were 100 and the royalty was 95.

[11] These examples are simplified, as an intangible could both increase selling prices and reduce unit costs.

[12] The licensor can only receive 100 percent of the (nonvolume) benefit accruing to a licensee when the denominator of the PLI is unaffected by the intangible (*i.e.*, revenue is unaffected by changes in the cost of goods sold.)

[13] It is unrealistic to think that an intangible could generate only one type of benefit (volume or profit margin), as enumerated in these examples. Rather, some intangibles are more (less) volume-focused than others. These examples are illustrative for mathematical simplicity.

[14] The licensor would also receive no royalty if operating profit/total costs were the chosen PLI.

[15] A good review of this point can be seen in Clark, Richard, "Choosing a Reliable Profit Level Indicator" (5 *Transfer Pricing Report* 807, 4/09/97).

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turn on equity, return on assets, etc.)[16] Using the information from Table 3 with a return on equity PLI below shows *all* of the intangible profit being sent to the licensor.[17]

Table 4: Profit Calculation Under CPM for an Intangible that Allows Licensee to Increase Its Volume (Return on Equity)

Financial Item	Licensee without Intangible	Licensee with Intangible
Net Sales	200	600
Cost of Goods Sold	150	450
Gross Profit	50	150
Operating Expenses	40	120
Operating Profit	10	30
Average Equity	100	100
Return on Equity	10 percent	30 percent
Routine Return on Equity		10 percent
Royalty as a Percent of Equity		20 percent
Implied Royalty as a Percent of Sales		3.3 percent
Royalty		20
Profit Remaining with Licensee		10
Intangible Profit Kept by Licensee		0

It is interesting to note that under this approach, while the licensee earns the same profit with or without the intangible, its operating profit margin with the intangible (after payment of the royalty) is *lower* than without the intangible.[18] That is, the volume effects require a licensee who pays for the entire value of the intangible to earn lower operating margins than the routine companies being used as benchmarks.

While such an approach does provide the licensor with all of the intangible profits being earned by the licensee, the structure of the royalty payment (percentage of equity) differs from the standard structure seen among related parties. That is—partially due to its simplicity to track—sales (or revenue) are the most common base from which to set royalties. For example, although the fast food restaurants described above represent some of the better-known intangibles producing volume effects, they often peg their royalties to franchisee sales.

Whether arm's-length pricing will provide the licensor with all of the intangible profit is also subject to interpretation. The other intangible licensing methods specified in the regulations do not suggest that the licensor needs to receive all intangible income. In fact, the (residual) profit split method explicitly splits the intangible income between licensor and licensee. A common "rule of thumb" used in licensing is that the licensor will receive 25 percent of the licensee's total profits. As seen below, this rule of thumb can produce higher or lower royalties than a (operating margin) CPM.

Table 5: Comparison of CPM (Operating Margin) and Rule of Thumb Royalty Rates

Licensee	CPM Royalty	Rule of Thumb Royalty
Firm from Table 1	95	27.5
Firm from Table 2	50	15
Firm from Table 3	0	7.5

The discussion above largely focused on the *license* of intangible property, but similar issues arise with the purchase of intangible property, such as cost sharing buy-ins. As shown by the number of articles on the subject,[19] the *valuation* of intangible property for cost sharing buy-in purposes already is one of the more contentious issues in transfer pricing. As the debates continue, it is important to remember that a royalty based on an (income statement) CPM analysis need not capture all of the *value* of the intangible property being used.

Conclusion

The CPM potentially can provide licensees with more than a routine level of profit. This methodology, which essentially backs into the royalty rate through a "residual" [20] approach, often does not incorporate a licensee's volume increases. The use of an equity or asset-based PLI (if applicable) may minimize this volume effect, however.

The implications of this issue apply both in licensing and purchasing of intangible property. A royalty that remits only a portion of the intangible profit to the licensor may be an arm's-length payment for the use of such intangible, but it need not be reflective of the value of the intangible.

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[16] Economic theory generally focuses the definition of profit rate on some type of return on capital. Equity and asset levles of tested parties (subsidiaries) are not always easy to ascertain. *See* Higinbotham, Harlow, "The Profit Split Method: Effective Application for Precision and Administrability" (5 *Transfer Pricing Report* Special Report, 10/02/96).

[17] This example is somewhat simplistic, as there often are requirements for more equity as the company grows. Equity remains constant in this example.

[18] In this example, the licensee's operating margin—after the payment of the royalty—would be 1.7 percent.

[19] *See*, for example, Becker, Brian, "Valuing In-Process R&D for Acquisitions: Economic Principles Applied to Accounting Concepts" (9 *Transfer Pricing Report* 323, 9/20/00) and Faiferlick, Christopher; Ackerman, Robert; Wills, John; and Reichert, Timothy, "Market Capitalization: Not a Reliable Transfer Pricing Method" (9 *Transfer Pricing Report* 753, 2/21/01).

Also see, for example, Becker, Brian, "Cost Sharing: Buy-Ins," *Corporate Business Taxation Monthly*, Vol. 3, No. 3, December 2001, pp. 26-35 and Wills, John, "Valuing Technology: Buy-In Payments for Acquisitions," *Global Transfer Pricing* (CCH), February-March 1999, pp. 28-34.

[20] The royalty is calculated as the difference between actual licensee profits and the profit levels consistent with similarly situated companies that do not own valuable intangible property.