

Approaches to valuation of intangible property

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In recent years, there has been an increasing number of cross-border transfers of intangible property ("IP") between related parties. Related-party transactions involving IP are usually material and attract scrutiny from the tax authorities. The OECD outlines inappropriate valuation of IP as a key risk related to profit shifting. This article explores general valuation techniques that can be used for determining and defending an arm's length price in IP transfers between related parties.

The IP valuation for transfer pricing purposes can be based on three general approaches to valuation: market, income, or cost. The OECD Transfer Pricing Guidelines¹ recognise that valuation techniques can be used in identifying the transfer price as long as their application is consistent with the arm's length principle. Alternative methods for valuing IP for transfer pricing purposes are summarised and presented in the table below:²

Approach	Valuation method	Description	Possible transfer pricing method from OECD perspective
Market approach is used to estimate the value of IP by reference to the "market" price.	Relief-from-royalty method	The method is based on a forecast "deemed royalty" payable for the right to use IP, which is discounted to the present value estimate. Typically, the estimation basis is licence agreements for comparable IP identified either as a result of the benchmarking study or based on internal comparable data.	The deemed royalty is typically based on the royalty rates observed in the market based on a search under the comparable uncontrolled price ("CUP") method.
	Premium price/profit method	The method is based on the forecast profit differential from a price premium of products using certain IP over usual substitute products (e.g. branded products over non-branded products), which is discounted to the present value estimate.	The premium profits stem from comparison of CUP for products containing the IP with prices for the generic product.
Income approach is used to identify the net present value of future income associated with owning and using the IP.	Residual value method	The method is based on the present value of free cash flows from products and services containing the IP. The full forecast of profits/ cash flows is typically adjusted for a routine profit from routine business activity.	A routine profit is benchmarked under the principles of the transactional net margin method (TNMM).
	Excess earnings method	The method determines an IP value as the present value of cash flows attributable to the IP after excluding the proportion of cash flows attributable to other assets. Applying the method may prove to be difficult since it first requires valuing all of the	Similar to the above, TNMM can be applied, but instead of deducting a routine profit from other activities, a return on contributory assets is deducted. These returns on identifiable assets may

Cost-based approach connects an IP value with a measure of its cost.	Historical cost method	The method involves capitalising historical costs incurred in developing the IP.	Similar to the Cost-Plus method, which accounts for underlying costs; especially if the historic/ replacement costs are recorded with the inclusion of a (limited) profit element (markup).
	Replacement cost method	The method involves capitalising forecast costs to be incurred in replacing the IP (the total development cost of a new IP with the same functionality).	

To conclude, when choosing which valuation method to apply for transfer pricing purposes, it is vital to consider the availability of internal information on the tested IP and external information on potential market comparables, as well as ensuring that the chosen method is consistent with the arm's length principle.

¹ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (2017).

² European Commission. Study on the Application of Economic Valuation Techniques for Determining Transfer Prices of Cross-Border Transactions between Members of Multinational Enterprise Groups in the EU (2016)