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# Transfer pricing of intangible assets - Implications of Finnish intellectual property case law on valuation of intangible assets

Accounting
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Anne Laine
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Master's Thesis
Anne Laine
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School of Economics

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# TRANSFER PRICING OF INTANGIBLE ASSETS – IMPLICATIONS OF FINNISH INTELLECTUAL PROPERTY CASE LAW ON VALUATION OF INTANGIBLE ASSETS


## PURPOSE OF THE STUDY

The purpose of the study is to examine whether intellectual property case law in Finland can help answering the question of how transactions involving intangible assets should be valuated between associated enterprises in transfer pricing. The alternative valuation approaches studied in this paper are the market approach, the income approach and the cost approach. The study furthermore examines how the definition of an intangible asset and the determination of who is entitled to the benefits arising from the intangible asset affect the valuation of the intangible asset. By following the foremost principle of transfer pricing, the arm's length principle, disputable questions between associated enterprises should be solved primary by reviewing how unrelated parties would have solved the same question. Disputes between unrelated parties regarding intangible assets are discussed in intellectual property case law and, thus, this study seeks to find an answer to a transfer pricing question from the intellectual property case law.

## RESEARCH METHOD AND DATA

The study is a qualitative and explorative research. The data comprises intellectual property case law decisions in Finland and, in addition, three expert interviews are conducted for the study. The data consists of twelve Supreme Court's precedents and two Court of Appeal's decisions that 1) deal with patent, copyright or trademark infringements and 2) take sides regarding definition, ownership and/or valuation of intangible assets and 3) include sufficient reasoning on how the court reached its decision.

## FINDINGS

The findings of the study suggest that intellectual property case law in Finland can be useful in solving transfer pricing disputes regarding intangible assets. Intellectual property case law has discussed the question of what is an appropriate approach to valuate intangible assets and the reasoning adopted by the court to determine a value of an intangible asset is consistent with the accepted methods of transfer pricing. The case law examination provided support for the market approach as the preferred valuation approach to valuate intangible assets. The market approach implies the application of the comparable uncontrolled transaction method in transfer pricing. If the market approach cannot be applied the income approach, and the transactional profit split method, is the most appropriate valuation approach. The findings, furthermore, suggest that in the valuation of intangible assets the definition of an intangible asset cannot be broadened over its legal definition to cover soft intangibles if the value importance of the soft intangibles cannot be objectively proven. Finnish intellectual property case law, in turn, is not able to help the transfer pricing arena in answering whom economic benefits arising from an intangible asset should be allocated in unclear economic ownership situations.



## KEYWORDS

Intangible asset, transfer pricing, intellectual property law, arm's length principle, associated enterprise, unrelated party

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# AINEETTOMAN OMAISUUDEN SIIRTOHINNOITTELU – SUOMALAISEN IMMATERIAALIOIKEUDEN OIKEUSKÄYTÄNNÖN VAIKUTUKSET AINEETTOMAN OMAISUUDEN ARVONMÄÄRITYKSEEN

## TUTKIELMAN TAVOITTEET

Tämän tutkielman tavoitteena on tutkia voidaanko suomalaisella immateriaalioikeus oikeuskäytännöllä vastata kysymykseen miten aineettoman omaisuuden arvo tulisi siirtohinnoittelussa määrittää. Vaihtoehtoiset arvonmääritystavat, joita tämä tutkielma tutkii ovat markkinaperusteinen, tuloperusteinen ja kustannusperusteinen lähestymistapa. Tutkielman tavoitteena on lisäksi tutkia miten aineettoman omaisuuden määritelmä ja taloudellisten tuottojen jakaminen konserniyritysten välillä vaikuttaa aineettoman omaisuuden arvonmääritykseen. Siirtohinnoittelun johtavaa periaatetta, markkinaehtoperiaatetta, seuraten epäselvät siirtohinnoittelukysymykset konserniyhtiöiden välillä tulisi ensisijaisesti ratkaista tavalla, jolla riippumattomat osapuolet olisivat ratkaisseet saman tilanteen. Aineettomaan omaisuuteen liittyvät kiistat riippumattomien osapuolien välillä ratkaistaan immateriaalioikeuksia käsittelevässä tuomioistuimessa ja sen vuoksi tämä tutkimus pyrkii löytämään vastauksen siirtohinnoittelukysymykseen immateriaalioikeuksia käsittelevästä oikeuskäytännöstä.

## TUTKIMUSMENETELMÄ JA LÄHDEAINEISTO

Tutkimus on laadullinen ja exploratiivinen tutkimus. Tutkimuksen lähdeaineisto on suomalainen immateriaalioikeuksia käsittelevä oikeuskäytäntö, jonka lisäksi kolme asiantuntijahaastattelua on suoritettu tutkimusta varten. Lähdeaineisto koostuu 12 korkeimman oikeuden ennakkotapauksesta ja kahdesta hovioikeuden päätöksestä, jotka 1) koskevat patentti-, tavaramerkki- tai tekijänoikeusloukkauksia ja 2) ottavat kantaa aineettoman omaisuuden määritelmään, omistajuuteen tai arvonmääritykseen ja 3) sisältävät riittävästi tuomioistuimen perusteluita ratkaisuun päätymisestä.

## TULOKSET

Suomalainen immateriaalioikeus oikeuskäytäntö voi olla hyödyksi ratkaistaessa aineettomaan omaisuuteen liittyviä kiistoja konserniyhtiöiden välillä siirtohinnoittelussa. Immateriaalioikeus oikeuskäytäntö on ottanut kantaa mikä on oikea tapa arvostaa aineetonta omaisuutta ja perustelut, joita tuomioistuin on ratkaisuissaan käyttänyt, ovat yhtenevät siirtohinnoittelussa hyväksyttävien periaatteiden kanssa. Tutkimustulokset osoittavat että ensisijaisesti aineettoman omaisuuden arvo tulisi määrittää markkinaperusteisella lähestymistavalla, joka siirtohinnoittelumenetelmistä tarkoittaa markkinahintavertailumenetelmän soveltamista. Mikäli markkinaperusteista lähestymistapaa ei voida soveltaa, tulisi tuloperusteista lähestymistapaa ja siirtohinnoittelun voitonjakamismenetelmää soveltaa. Tutkimustulokset osoittavat myös, että arvonmäärityksessä aineettoman omaisuuden määritelmään ei voida sisällyttää laillisen määritelmän ulkopuolelle jääviä, niin kutsuttuja pehmeitä aineettomia eriä, mikäli niiden vaikutusta omaisuuden arvoon ei voida objektiivisesti osoittaa. Immateriaalioikeuksia käsittelevä oikeuskäytäntö ei puolestaan kykene vastaamaan miten tuottojen allokointi epäselvissä omistustilanteissa konserniyhtiöiden välillä tulisi siirtohinnoittelussa ratkaista.

## AVAINSANAT

Aineeton omaisuus, siirtohinnoittelu, immateriaalioikeus, markkinaehtoperiaate, konserniyritys, riippumaton yritys

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# 1. Introduction

## 1.1. Increased role of intangible assets in business

Market values of companies have heavily increased over the long haul. The amount of tangible assets in companies' balance sheets, however, has not incremented in step with the total market values of companies. The factor behind companies' increased market values is intangible assets. The importance of intangible assets in companies business has increased tremendously during recent years. [1] Growing globalization and the rise and consolidation of know-how based industries like telecommunications, technology and pharmaceutical has incremented significantly the importance of intangible assets in companies' balance sheets [2]. Intangible assets have truly become the main drivers of economic value creation and economic growth of companies and they contribute remarkably to an enterprise's competitive advantage[3]. Since values of the companies are nowadays increasingly related to the intangibles assets, the right valuation of intangibles for accounting, finance and tax purposes has become essential.

The rise of intangible assets has had and still has significant effects on the valuation field that tries to valuate intangibles for different purposes. During the last few years the financial standard bodies have placed greater emphasis on recognizing and valuing intangible assets for financial reporting purposes.[4] Transfer pricing literature and regulation, on the other hand, until present has largely ignored intangible assets despite the fact that intangibles have characteristics that make them significantly different from tangible assets. [5]

After a long time of oversight of intangible assets' special needs, intangibles have become a hot topic also in transfer pricing. Transfer pricing practitioners have noticed that since intangible assets have special characteristics they differ to a great extent from tangible assets and, hence, the current transfer pricing rules, made in a more tangible business environment, might not be appropriate for intangibles. Special characteristics that mark intangible assets out

[1] Hulten, C & Hao, X, 2008, 1
[2] Abdallah, W & Maghrabi, A, 2009, 116
[3] Przysuski et al. 2004, 10
[4] Finan, W & Work, S, 2009, 3
[5] Johnson, N, 2006, 357

from other assets are that intangibles are often nonphysical, nonmonetary, unique assets that are based on know-how or on legal protection[6].

Another important feature is that intangible assets do not only differ from tangible assets, but they also differ to a great extent from one another, which make their measurement and regulation extremely challenging[7]. As in many cases intangible assets are unique in nature and there are no two similar assets, questions regarding what is an intangible asset, who is the owner of the asset and how the value of the asset should be determined, may be difficult to answer.

### 1.2. Transfer pricing and OECD transfer pricing guidelines

Academic literature includes various slightly different definitions for transfer pricing. In general and in this research transfer pricing means the pricing of transactions between associated enterprises.[8] Associated enterprise is defined in the OECD (Organisation for Economic Co-operation and Development) Model Tax Convention as an enterprise where *a)* an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or *b)* the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State[9].

A common thread of transfer pricing is the arm's length principle, which means that prices used in transactions between associated enterprises should be equal to prices used in similar situations between unrelated parties. [10] No peremptory legislation for transfer pricing exists, but instead transfer pricing leans on transfer pricing guidelines and practice. In Finland Finnish Tax Administration follows in transfer pricing questions the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* that are generally accepted and followed transfer pricing guidelines by the OECD member countries. The latest version of the guidelines was updated and published in July 2010. These guidelines are a revision of the OECD Report *Transfer Pricing and Multinational Enterprises* (1979) that since then has been revised several times. The OECD transfer pricing guidelines are general guidelines that seek to answer the questions of associated company transactions.

[6] Boos, M, 2003, 16-17
[7] Baruch, L, 2001
[8] Karjalainen, J & Raunio, M, 2007, 14
[9] OECD Model Tax Convention, Article 9
[10] OECD Transfer pricing guidelines, Chapter I

The purpose of the OECD guidelines is to provide guidance on the application of the arm's length principle for the valuation, for tax purposes, of cross-border transactions between associated enterprises. The guidelines are made for global economy where multinational enterprises (MNEs) have a central role and governments need to ensure that the taxable profits of MNEs are not artificially shifted out of their jurisdiction and that the tax base reported by MNEs in their country reflects the economic activity undertaken in that country. Also for taxpayers, it is fundamental to limit the risks of economic double taxation that may derive from a dispute between two countries on the determination of the arm's length compensation for their cross-border transactions with associated enterprises. [11]

The international taxation principles, to which also the transfer pricing guidelines are based on, have been chosen by the OECD member countries as serving the dual objectives of securing the appropriate tax base in each jurisdiction and same time avoiding double taxation and thereby minimizing conflict between tax administrations and promoting international trade and investment. [12]

The guidelines, however, are general in nature and directed to transactions involving all types of assets. The nature of intangible assets makes transfer pricing for intangibles particularly complex matter that gives rise to several questions. The appropriateness and sufficiency of the current guidelines for transactions involving intangible assets have recently been questioned on a constant basis. Finnish Tax Administration, among others, has also noted the rise of transfer pricing disputes and the increased role of intangible assets in these disputes. Finnish Tax Administration has centralized all transfer pricing questions to its Large Taxpayers' Office and the Transfer pricing project that has been operating since the beginning of the year 2012 is putting significant emphasis on transactions involving intangible assets[13]. The reason for such increased attention is that transactions involving intangibles tend to raise several disputable and unclear questions that the transfer pricing guidelines are not able to answer between taxpayer and tax administration. And since transactions involving intangible assets may also be monetarily significant, they may have relevant implications on taxpayers' tax burden. [14]

[11] Preface, OECD Transfer pricing guidelines
[12] Preface, OECD Transfer pricing guidelines
[13] Tax Administration Bulletin 18.01.2012
[14] OECD, Transfer Pricing and Intangibles: Scope of the OECD Project, 2011

### 1.3. Turmoil in intangible assets' transfer pricing

In order to respond to the problems stemming from the transfer pricing arena the OECD Committee on Fiscal Affairs has commenced a new project examining the transfer pricing aspects of intangibles. In January of 2011 the OECD released a scoping document informing that the current transfer pricing guidelines regarding intangible assets are in need of updating and, hence, they will be updated in forthcoming years.

OECD's scoping document regarding transfer pricing of intangible assets notes that there is nothing inherently wrong in the current guidelines for intangibles but the problem has rather been that they are insufficient and unclear and, thus, they leave too many disputable questions for taxpayers and tax administrations to debate about. The scoping document recognizes that there is currently significant difficulty, for taxpayers and tax administrations, about the treatment of intangibles for transfer pricing purposes. This difficulty leads to many complex and monetarily significant transfer pricing disputes and to risks of double or less-than-single taxation. The OECD believes that the development of clearer and consensus-based international guidance on the transfer pricing aspects of intangibles could help limiting this uncertainty and those risks. [15]

The revision of the current guidelines is being carried out by Working Party No. 6 of the Committee on Fiscal Affairs on the Taxation of Multinational Enterprises, through a Special Session on the Transfer Pricing Aspects of Intangibles ("WP6 TPI") set up for this purpose. The purpose in particular is to revise the guidance regarding the definition, identification, ownership and valuation of intangible assets. Currently, the guidance on these matters is insufficient and it does not take sufficiently into consideration the special characteristics of intangible assets and therefore especially these questions are being carefully revised by Working Party No. 6. [16]

In order to get better insight into the Working Party No. 6 work and to understand why transfer pricing of intangible assets causes so many unclear questions I was given a chance to interview Mr. John Henshall, who is a Global Transfer Pricing Partner of Deloitte UK and representative of Deloitte in Working Party No. 6' work. Mr. Henshall's interview gives extremely valuable reasoning and insight for this research and, therefore, before explaining in

[15] OECD, Transfer Pricing and Intangibles: Scope of the OECD Project, 2011
[16] OECD, Transfer Pricing and Intangibles: Scope of the OECD Project, 2011

detail the purpose of this research, the problems regarding intangible assets' transfer pricing and Working Party No. 6's work will be illustrated based on Mr. Henshall's interview.

The discussion with Mr. Henshall starts by noting that Working Party No. 6 task is definitely not straightforward. Questions regarding intangible assets' definition, ownership and valuation are currently widely debated problems among transfer pricing experts. The current discussion, however, has shown that the topic is frequently being seen from slightly wrong and too complex perspective. With this comment Mr. Henshall refers that the fundamental idea of the renewal of the guidelines concerning intangible assets is not to discover new courses of actions only for transfer pricing purposes because, in fact, many of the disputes that are now under the revision of Working Party No. 6 have already been answered between third parties in commercial courts. Problems concerning intangible assets' definition, ownership and valuation are not new-found nor have they emerged due to transfer pricing. Intangible assets were not invented for tax purposes or transfer pricing purposes but *intangibles are commercial assets that can be of great value and importance, which have been part of commercial life for many years.* [17]

A reasonable question at this point is probably to consider why would the transfer pricing arena care about how problems relating to intangible assets are managed in commercial courts? The answer lays in the arm's length principle. The arm's length principle is the foremost principle of transfer pricing and it suggests that transfer pricing practice should learn from an example of what is happening in a similar situation in a real world between unrelated parties. Hence, the question that should be asked in the transfer pricing arena is; what would independent companies do in comparable transactions in comparable circumstances? Disputes between independent parties regarding intangible assets like patents, copyrights and trademarks have for long time been solved in legal praxis. Case law on disputes concerning patents, copyrights and trademarks already exists. Therefore what transfer pricing field should do, in order to follow the arm's length principle, is to examine the existing case law concerning intangible assets and to see if in disputes between unrelated parties case law has already answered the same questions that are now under debate between related parties in transfer pricing. In order to follow the arm's length principle transfer pricing guidelines should be formed based on real-life examples, because all in all the basic idea of transfer pricing is rather simple. The arm's length principle seeks to establish the conditions of

[17] John Henshall, interview 2.2.2012

controlled transaction to the same level that comparable uncontrolled transactions would be at. [18]

Mr. Henshall argues that in order to follow the arm's length principle, the new transfer pricing guidelines should be, if possible, based on real-life examples. New, common guidelines for intangibles' transfer pricing are definitely needed in order to better guide taxpayers' and tax administrations' work. Currently there is nothing inherently wrong in the current transfer pricing guidelines and, thus, totally new rules that are merely invented for transfer pricing purposes should not be discovered. However, the current guidelines should be explained, expanded and clarified and it should be done based on real-life examples. At the moment, the guidelines are unclear and insufficient and they don't meet up the current business environment where intangible assets play an important role. This, in turn, leads to uncertain situations both on taxpayers' and on tax administrations' side. [19]

The transfer pricing expert sums up the discussion of the Working Party No. 6 work by saying that; the key issue is to understand the special characteristics of intangible assets. Problems with transfer pricing of intangibles can frequently be traced to lack of understanding of what intangibles are, who owns them and how third parties transact with them. Before trying to make valuation method recommendations for intangibles it is important to understand the basic nature of intangible assets and how the nature of intangibles effect on their ownership and valuation. [20]

### 1.4. Purpose and research question

The purpose of this study is to examine whether intellectual property case law in Finland can answer the question of how transactions involving intangible assets should be priced between associated enterprises. Transfer pricing practice and previous research into intangibles' transfer pricing has demonstrated that difficult transfer pricing questions resulting from transactions involving intangible assets may be solved by reviewing intellectual property case law on similar transactions between independent enterprises. Since intangible assets have not been invented for transfer pricing purposes and transactions between associated companies should follow the arm's length principle, intellectual property case law examples in

[18] John Henshall, interview 2.2.2012
[19] John Henshall, interview 2.2.2012
[20] John Henshall, interview 2.2.2012

commercial courts could be expected to answer the questions that are now under debate between associated parties in transfer pricing. [21]

A common thread of this research is the arm's length principle that is the foremost principle of transfer pricing. The arm's length principle implies that transactions between associated parties should be priced as if the transaction had occurred in the open market between unrelated parties. Therefore, if transfer pricing practitioners are expected to follow the arm's length principle, it can be assumed that disputes between associated enterprises should be solved, whenever possible, in a similar manner than unrelated parties would have solved the similar problem. Hence, in the light of the arm's length principle it would make no sense that a transfer pricing body dealing with an associated company tax matter would strike out to different direction than the commercial court when dealing with a similar problem in similar conditions[22]. Therefore, the important question is to examine whether commercial courts considering intellectual property cases have confronted the same questions that transfer pricing is now dealing with. These questions include the definition of intangible assets, who is the owner of an intangible asset and how intangible asset should be valuated. Definition and ownership assessment is, however, generally needed in order to valuate the asset for transfer and, therefore, the ultimate objective of this research is to answer the question of how transactions involving intangible assets should be priced.

Transfer pricing arena is currently lacking consensus on what basis transfer prices in transactions involving intangible assets should be set in the case that direct arm's length prices are not available. Transfer pricing practice has debated between three valuation approaches that all derive from corporate finance. These approaches are the market approach, the income approach and the cost approach. The idea of this research, therefore, is to seek to answer the question of what is the most appropriate approach to valuate intangible asset by reviewing transactions between third parties. After finding the most appropriate approach to valuating intangible assets, another goal of the paper is to analyze which of the current transfer pricing methods correspond to the selected approach. The nature of transfer pricing also brings into question the role of comparability in the valuation and in the selection of the appropriate approach.

[21] Francescucci, D & Henshall, J, 2012, 1-4
[22] Francescucci, D & Henshall, J, 2012, 1

Albeit finding the most appropriate approach to valuating intangibles is the ultimate objective of this research, factors that influence significantly the valuation of these assets must be discussed first in order to understand the basis of the valuation problems. Two important factors that Working Party No. 6 has brought into question are the definition and the ownership of intangible assets.

Question of definition implies asking the basic question of what is an intangible asset and how does the definition of an intangible asset affect the determination of an appropriate transfer price? An important question that the transfer pricing arena has recently been asking is; to what extent the definition of intangible asset can be broadened from the legal definition. This includes questioning to what extent soft intangibles, which are non-legally protected intangible assets, can be included in the valuation of intangible assets. The question of ownership, in turn, refers to who is entitled to the benefits arising from an intangible asset. Transfer pricing practice has recently discussed the possible separation of the economic ownership and legal ownership of the asset. Thus, considering the special characteristics of intangible assets, the questions of what is being priced and to whom the profits of the valuation should be allocated must be understood before jumping into the valuation.

Although transfer pricing is an essential question of international taxation and the problems that transfer pricing is now dealing with are tax problems, the focus of this research is not on taxation. Problems regarding intangible assets' definition, ownership and valuation create tax problems in transfer pricing. Taxation, however, has not created problems regarding intangible assets' definition, ownership and valuation but its role has rather been in detecting them. Therefore, as taxation is not the source of these problems international taxation issues in general level, such as double taxation, avoidance of taxation and their discussion in tax treaties and in domestic law are out of the scope of this study.

The study furthermore concentrates on individual transfer of an intangible asset between associated parties. It does not discuss possible special characters that might come into the picture when the transfer is part of business restructuring. Readers, however, will be aware that findings of this study may also fit transfers occurred in business restructurings even though as such they are being left out from the scope of this study.

So far similar studies have been performed in the US, the UK and Canada and they all have shown that in many cases intellectual property case law decision can offer valuable answers to

transfer pricing as well. In Finland no such study has ever been made before and that is what makes this research highly interesting. So far there is no previous evidence on whether intellectual property case law in Finland can be used and to what extent to answer transfer pricing disputes involving intangible assets.

This study, therefore, aims to give guidelines on how transfer pricing disputes where intangible assets play a key role, could be solved by reviewing Finnish intellectual property case law. The objective of this study is not only to address the difficulty and key questions regarding intangible assets' transfer pricing, but also to offer justifiable, Finnish case law -based, reasoning for the valuation choices of intangible assets.

### 1.5. Research method and structure of the study

This research is a qualitative and explorative research. The subject of the research is intangible assets' transfer pricing but the research material is intellectual property case law in Finland. The research is exercised by examining Finnish intellectual property case law. Intellectual property in this context includes patents, copyrights and trademarks. The cases investigated in this study are mainly Supreme Court's precedents but also two Courts of Appeal's decisions are included in the study. The Court of Appeal's decisions in this study, however, are the highest level of court decisions in these cases because further leave to appeal to Supreme Court was not granted. Decisions of district courts, on the other hand, are being left out from the analysis due to their minor impact. The database of the cases is www.finlex.fi. Finlex is the databank of statutes of the State of Finland. In Finlex database all Supreme Court's and a share of the Court of Appeals' decisions are published. Supreme Court decisions are published starting from 1926 and Court of Appeal's decisions starting from 1964. The earliest decisions however lack the complete reasoning adopted by the court and, therefore, they are being left out from this study. The earliest decisions relevant to this study are from the year 1989. The cases that were published in the database by 27.4.2012 have been taken into consideration.

From all the Supreme Court's and Court of Appeal's cases published in the Finlex database, the ones selected for the research material are the cases that meet all the following requirements: 1) the case deals with patent, copyright or trademark infringements and 2) the case takes sides regarding definition, ownership and/or valuation of intangible asset and 3) the

court decision includes sufficient reasoning on how the court reached its decision. There are 14 cases in total that meet the requirements of the study. The cases are the followings:

Patents: KKO:2003:127

Copyrights: KKO:1989:87, KKO:1989:151, KKO:1996:43, KKO:1995:202, KKO:1998:91, KKO:1999:115, KKO:2001:42, KKO:2005:43, KKO:2007:63, KKO:2010:47 and KKO:2011:92, Court of Appeal (15.11.2007 3699)

Trademarks: Supreme Court KKO:2005:105/Court of Appeal 2552.

In order to get a broader perspective for analyzing the findings of the case law, three expert interviews are also being carried out. These interviews represent both the intellectual property law perspective and the transfer pricing perspective. The interviews are conducted as an open discussion interviews where the interviewees discuss the topic from their perspective without a ready-made structure of the interview. The interviewees are the following:

Mr. John Henshall, Global Transfer Pricing Partner, office based in Deloitte's Reading office. Mr. Henshall is also Deloitte's representative in Working Party No. 6 work.

Mr. Jukka Karjalainen, Partner and the head of transfer pricing and tax aligned supply chain for Deloitte Finland

Mr. Henri Kaikkonen, Lawyer (LL.M.), specialized in intellectual property law, Attorneys-at-Law Juridia

The structure of the paper is the following; as the definition and the ownership analysis form a basis for the valuation the paper starts with presenting the discussion regarding intangible assets' definition and ownership. After presenting the factors affecting the valuation, the paper concentrates on the valuation of intangible assets. All of these three topics are discussed separately by presenting transfer pricing guiding, intellectual property law and previous academic discussion regarding each topic. After the institutional background and the academic literature concerning definition, ownership and valuation of intangible assets has been set, the paper moves on to discuss the role of case law in guiding transfer pricing practice and presents similar intellectual property case law studies made in other OECD member countries. Foreign cases are presented for the reader to get better understanding on how intellectual property case law decisions may offer answers for intangible assets' transfer pricing. Foreign case law illustration also serves as a basis for further evaluation whether these decisions can be used in Finland in such situations that our own intellectual property

case law has not answered a particular question yet. After reviewing case law examples from other OECD member countries, the paper concentrates on the empirical part of the paper; analyzing intellectual property case law in Finland and its implications on intangible assets' transfer pricing. Five cases are explained and analyzed in detail for the reader and nine cases are discussed simultaneously in one chapter because they all provide similar evidence. Summary of the case law findings is presented in chapter 8. Conclusions of the study are naturally discussed ultimately.

# 2. Definition

## 2.1. Transfer pricing defines intangible property

The OECD in its *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* uses the term "intangible property" instead of the term "intangible asset". The OECD transfer pricing guidelines do not include specific definition for intangible property but the paragraph 6.2 defines the scope of intangible property in the following manner:

"Intangible property includes rights to use industrial assets such as patents, trademarks, trade names, designs or models. It also includes literary and artistic property rights, and intellectual property such as know-how and trade secrets."

Different types of intangible assets are classified and named in various ways. Besides the term "intangible property" the OECD uses the term "commercial intangible" because the guidelines are focused for business rights; intangible property involved in commercial activities. These commercial intangibles may have significant value even though they would not be in companies' balance sheets. Commercial intangibles include patents, know-how, designs, and models that are used for the production of a good or the provision of a service and intangible rights that are business assets themselves and can be used in a business or transferred to customers. Commercial intangibles can be further divided into two; trade intangibles and marketing intangibles. [23]

Marketing intangibles are trademarks, trade names, customer lists, distribution channels, and unique names, symbols or pictures that have promotional value for the product concerned.

[23] OECD transfer pricing guidelines, Paragraph 6.2-6.3

Some marketing intangibles, like trademarks, can be protected by the law but most of the marketing intangibles have only promotional value. The value of marketing intangibles depends on several factors. These factors include credibility and reputation of a trade name, quality of the goods and services traded under the same name, degree of quality controls in R&D or distribution and availability of the products have all value impact on marketing intangible. [24]

Trade intangibles, on the other hand, are commercial intangibles that are not marketing intangibles. They are usually created through risky and expensive research and development activities. The developer of the intangible seeks to gain revenues through product sales, service contracts or licensing. If the developer develops the intangible in its own name and own cost it retains both the legal and the economic ownership of the property. Trade intangible can also be developed in joint activities or in a contract arrangement with other group companies, which may lead to a sharing of legal and economic ownership.[25] Sharing of legal and economic ownership will be discussed in detail later on in the ownership –section.

Some intangibles property, like know-how or trade secrets, can be simultaneously trade intangibles or marketing intangibles. They are proprietary information or knowledge that assist or improve commercial activity. They are not, however, registered for protection like patents or trademarks. Paragraph 11 of the Commentary on Article 12 of the OECD Model Tax Convention defines know-how in the following manner: "[Know-how] generally corresponds to undivulged information of an industrial, commercial or scientific nature arising from previous experience, which has practical application in the operation of an enterprise and from the disclosure of which an economic benefit can be derived".

Even though patents, representatives of trade intangible, and trademarks, representatives of marketing intangible, are both intangibles that can be registered for legal protection, they differ in several aspects. First of all patents are normally used for production of a product while trademarks are used for promoting products. Patent also gives an exclusive right for the owner for a limited time period whereas trademarks' protection normally lasts for an indefinite time period. Patent can create monopoly for an owner but trademarks don't because competitors may produce the exact same product with a different name. Another difference is the cost of these assets. Normally patent is a result of an expensive research and development

[24] Paragraph 6.4
[25] Paragraph 6.3

processes whereas a creation of trademarks doesn't necessary require expensive investments. However later on, on the product's lifecycle, advertisement for maintaining the reputation of trademarks might become costly. [26]

## 2.2. Intellectual property law defines intellectual property

Intellectual property generally forms a part of intangible property. Intellectual property and intangible property do not necessarily have same meaning and, thus, these differences will be debated in the next section of the paper where previous discussion on intangible asset's definition is presented. This section in turn presents how intellectual property law defines intangible asset.

Intellectual property is a form of intangible asset in which legal ownership can be asserted. [27] Finnish legislation that decrees intellectual property is Copyright Act, Patents Act and Trade Marks Act. Finnish legislation includes specific definitions for the terms "copyright" and "trademark" but it does not include specific definition for the terms "patent" or "know-how"[28]. Definition of patent, however, can be found from official sources but the same does not apply to "know-how". Although the term "know-how" is widely used in discussions of intellectual property, it does not have a definition in Finnish legislation or in any other official source. However, in practice know-how is a recognized term and it refers to unique expertise gained through experience and testing [29]. Below official definitions of copyright, trademark, patent are discussed. Questions regarding intellectual property's ownership and valuation will be discussed later on under their respective titles.

**Copyright:** The subject and scope of copyright is defined in the section 1 of Chapter 1 of Copyright Act in the following manner:

"(1) A person who has created a literary or artistic work shall have copyright therein, whether it be a fictional or descriptive representation in writing or speech, a musical or dramatic work, a cinematographic work, a photographic work or other work of fine art, a product of architecture, artistic handicraft, industrial art, or expressed in some other manner.

[26] Paragraph 6.8-6.9
[27] Henshall, J, 2010, 3
[28] Karjalainen, J & Tättäläinen, S, 2005, 350, Chapter 9 Finland from Verlinden et al. 2005, *Mastering the IP life cycle*
[29] Karjalainen, J & Tättäläinen, S, 2005, 350, Chapter 9 Finland

(2) Maps and other descriptive drawings or graphically or three-dimensionally executed works and computer programs shall also be considered literary works. "

**Patent:** Patent, on the other hand, does not have specific definition in Finnish Patent Act. Legal practice, however, has formed a definition of patent under which a patent is an exclusive right which society has granted to an inventor who, in exchange therefore has to allow publication of his work[30]. A patent may be granted for an invention susceptible to industrial application that is novel and differs essentially from those that have become known previously[31].

**Trademark:** Trademark is defined in Section 1 of Chapter 1 of Trademarks Act. The definition is the following:

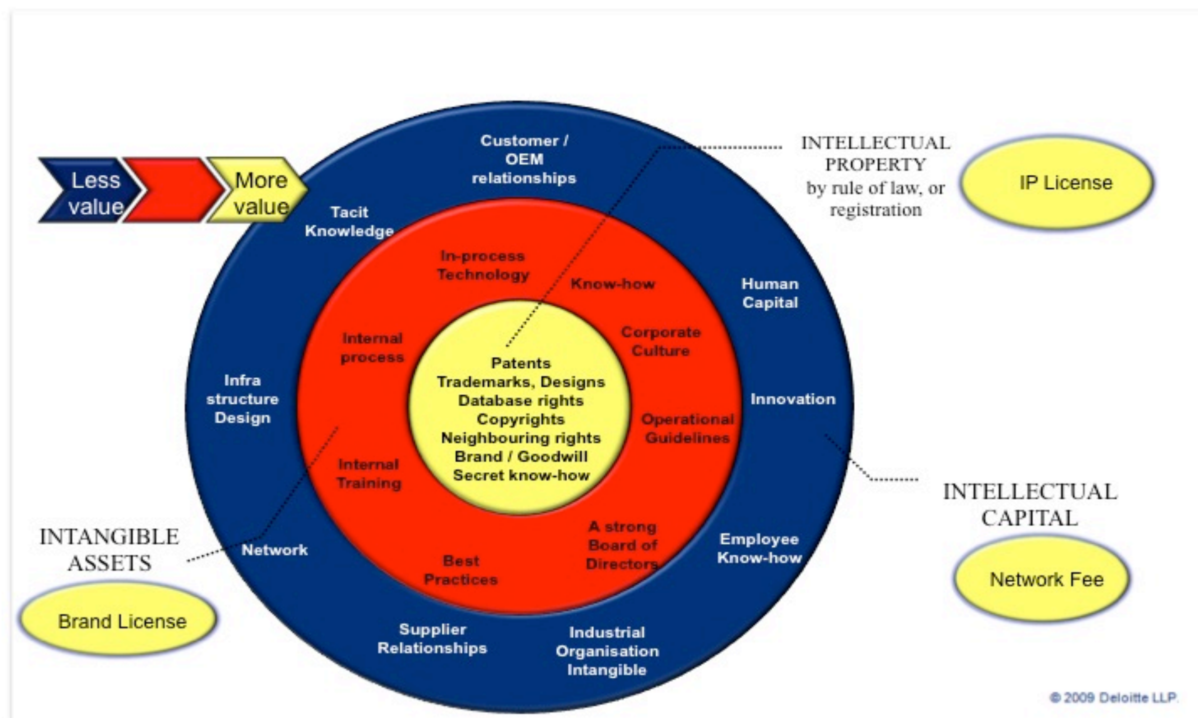
"Registration shall confer exclusive rights in a trademark as a special symbol for distinguishing goods to be offered for sale, or otherwise purveyed in business, from those of others. Any kind of mark that can be represented graphically and by means of which goods marketed in business can be distinguished from those of others may be a trademark. A trademark may in particular consist of words, including personal names, figures, letters, numerals or the shape of goods or of their packaging."

### 2.3. Previous discussion includes endless number of definitions

As seen in the previous section definition of legally protected intangible assets, so called intellectual property, is rather straightforward. The debate arises when the scope of intangible assets is broadened to cover also non-legally protected intangible assets. One classification of different types of intangible assets is presented in figure 1. Figure 1 describes the general problematic that the OECD Working Party No. 6 is now facing when trying to define different intangible assets that are consisted of different level of assets groups. Figure 1 shows that in the core of the intangible assets is the legally protected intellectual property whose value can be more easily ascertained. The farther you go from the center the lesser the value of the asset is. [32] Figure 1 represents one type of classification but current transfer pricing discussion includes various classifications of intangible assets and the variety of different type of intangibles will be discussed next.

[30] Karjalainen, J & Tättäläinen, S (2005), 350, Chapter 9 Finland
[31] Definition given on the website of the National Board of Patents and Registration of Finland
[32] Henshall, J, 2010, 3

FIGURE 1. CLASSIFICATION OF INTANGIBLE ASSETS




Researches on intangible assets agree no all-embracing definition for intangible asset exists. The attempt to define the term intangible asset will lead to the conclusion that there is lack of consensus about which elements exactly are included in this asset category. Endless number of definitions has been introduced for different purposes and the definitions made for legal, accounting, management, economic or tax purposes are usually purpose specific. Since transfer pricing is an interdisciplinary issue and it is not limited solely to tax or economics, the definition of intangible asset should be combined from all these purposes. [33]

Several terms are also being used interchangeably for intangibles, especially the terms "intangible asset" and "intangible property" are being often mixed up in academic research[34]. The OECD uses the term intangible property or commercial intangible, instead of intangible asset. The term commercial intangible has the same meaning as intangible property and the OECD uses the term because intangible property that it describes in the guidelines is used for commercial activities. For the OECD intangible asset, intangible property and commercial intangible have same meaning. But as said, different sources use different terms for

[33] Boos, M, 2003, 16
[34] Verlinden et al. 2005, 35

intangibles. Besides the terms intangible asset and intangible property more specific terms like intellectual property, commercial intangible, marketing intangible, trade intangible, hybrid intangible, "super" intangible and "soft" intangible are being used. General, non-specific term that is used to describe nonphysical assets of an enterprise is "intangibles". The term can be used to refer to all kinds of intangible assets regardless of their specific features.

**Intellectual property** Intangible assets may be defined in different manner for different purposes. From the legal perspective the term intangible asset refers to intellectual property whereas intangible asset for other purposes may include more than just the intellectual property.[35] In transfer pricing literature intellectual property refers to creations of the mind which are used in business, like inventions, artistic and literary work, models, design, images and the like. Intellectual property rights have several common features. Firstly they are intangible in nature. Secondly they can be legally registered and protected. In order to receive protection, works has to go beyond the mundane. The holder of an intellectual property has an exclusive right to exploit and commercialize the property and it can prohibit other parties from using it. Intellectual property can be transferred through sale or licensing individually. Intellectual property rights are normally territorially limited.[36]

While intellectual property rights have several common features and it is the type of intangible asset that is the most easy to define, it is also to be remembered that intellectual property may be interpreted differently for legal, tax or accounting purposes.[37] Intellectual property rights also differ in their use. Some intellectual property, like patent, relates to the manufacturing of a product, while other intellectual property, like trademark, relates to the branding or marketing of a product.[38]

**Soft intangibles** Intellectual property is less unclear definition compared to intangibles that are not legally protected. These non-legally protected intangibles include so called "soft" intangibles. Soft intangibles are not items of intellectual property but they are intangible assets. The role of soft intangibles, however, is not properly defined in transfer pricing and therefore the OECD's Working Party No. 6 project is currently focusing its effort on these soft intangibles. As said, the term "soft intangible" does not have specific definition but it is a nebulous concept. Soft intangibles can be for example available production capacity,

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[35] Herksen et al. 2008, 10
[36] Verlinden et al. 2004, 21-22
[37] Verlinden et al. 2005, 97
[38] Cordova et al. 2012, 47-48

workforce in place or strong performance history. It is obvious that soft intangibles are some form of intangible assets and therefore their importance for the value of the asset must to be evaluated each time when an intangible asset is being transferred. Due to the arm's length principle the intriguing and debatable question regarding soft intangibles in transfer pricing is how they are priced between third parties in the open market. [39]

Tax administrations have been frequently inclined to include soft intangibles into the transfer price of an intangible property even though value of these soft intangibles cannot be measured or proofed in any means. This has caused several unclear disputes in the case of a transfer of an intangible asset. According to real life examples in several OECD member countries, it can be seen that soft intangibles are not a reason for higher transfer prices. Soft intangibles do not add significant bargaining power to either entity in a transaction. Generally soft intangibles that are believed to add value will also be present in comparable companies. Thus, soft intangibles do not add measurable competition advantage and the value of soft intangibles has already been taken into account in comparable transactions. When comparable companies have same kind of soft intangibles, like "successful customer relationships", value of soft intangibles is already taken into consideration in the arm's length price. If it cannot be observed that soft intangibles have increased value of a transferred intangible asset in transactions between unrelated parties, "value increment" due to company's soft intangibles cannot be applied to related-party transactions either because it would be fundamentally against the arm's length principle. [40]

**Super intangibles** Soft intangibles might not add measurable value for a property that could be taken into account when setting a transfer price but so called "super" intangibles surely do. Where an intangible assets plays a key role for multinational enterprise to maintain its market position and where the profitability of the enterprise is sustained for longer in a given market than in normal situations a super intangible is involved. Super intangible may create barriers to market entry and, thus, hurdle competition in the market. Classic example of super intangible is the Coca-Cola brand, one of the most valuable trademarks in the world. The Coca-Cola brand certainly has more value than its pure legal trademark value is and in Coca-Cola's case "soft" intangibles turn the trademark into super intangible. In Coca-Cola's case value-adding power of the soft intangibles is already so evident that soft intangibles would be included in trademarks' transfer price. However, it is generally accepted that in principle such

[39] Henshall, J & Smith, G, 2012², 1
[40] Henshall, J & Smith, G,2012² , 3

intangibles are only transferred within a group and it is obvious that there exists no an arm's length benchmark. [41]

**Hybrid intangibles** Definitions of marketing intangible and trade intangible are similar in academic literature than they are in the OECD transfer pricing guidelines. Real-life, however, shapes intangible assets for different needs and therefore also hybrid intangibles exist. Hybrid intangible is a combination of marketing intangible and trade intangible. It can take endless number of different forms. The Coca-Cola beverage is good example also of hybrid intangible. The firm's reputation is a result of years of extensive marketing campaigns and, thus, it is clearly a marketing intangible. The secret recipe of the Coca-Cola beverage, on the other hand, is a trade intangible. [42] Hybrid intangible illustrates very well the problematic nature of intangible asset in general. It can take an endless number of forms and it can stem from the needs of a single enterprise and therefore comparable transactions, which are searched in transfer pricing are hardly found.

# 3. Ownership

## 3.1. Intellectual property law defines legal ownership

Intellectual property law defines the legal owner of an intangible asset. The legal owner of an asset is the party who holds the registration; copyright holder, patent holder or trademark holder. Copyright Act, Patent Act and Trademark Act all define what is required to acquire the exclusive legal ownership of the asset and what rights does the holder receive. In order to acquire legal ownership of a particular intellectual property, an asset must fulfil the definition of these assets described earlier in this paper. Intellectual property law further describes the rights of the registration holder.

**Copyright:** Section 2 of Chapter 1 of Copyright Act describes the economic rights of copyright; taking into consideration the specific limitation, the holder of a copyright is exclusively entitled to exploit a creation by producing copies and making them available to the public, in the original form or in a modified form, in translation or in adaptation, in another literary or artistic form, or by using a different technique.

[41] Verlinden et al. 2004, 42
[42] Verlinden et al. 2005, 99

**Patent:** Section 1 of Chapter 1 of Patents Act describes the avowal of patent: “Anyone who has made an invention which is susceptible of industrial application, or his successor in title, shall be entitled, on application, to a patent and thereby to the exclusive right to exploit the invention commercially, in accordance with this Act.”

**Trademark**: Section 1 of Trademark Act defines that trademark registration shall confer exclusive rights in a trademark as a special symbol for distinguishing goods to be offered for sale, or otherwise purveyed in business, from those of others. Any kind of mark that can be represented graphically and by means of which goods marketed in business can be distinguished from those of others may be a trademark. A trademark may in particular consist of words, including personal names, figures, letters, numerals or the shape of goods or of their packaging. Section 2 of Trademark Act states that exclusive rights in a trademark may be acquired, even without registration, after the mark has become established. Exclusive rights in symbols other than the special business symbols defined in section 1(2) may also be acquired through their becoming established. A trade symbol shall be considered established if it has become generally known in the appropriate business or consumer circles in Finland as a symbol specific to its proprietor's goods.

### 3.2. Transfer pricing sets out various ways to develop ownership

The OECD guidelines do not define in exact terms the ownership of an intangible asset; they only describe how ownership can be formed and possibly split. Like in legal context, also in transfer pricing a starting point for an ownership analysis is the legal ownership of an asset. Legal ownership furthermore can be split between several parties. This happens in Cost Contribution Arrangement (CCA) that is described in detail in Chapter VIII in the transfer pricing guidelines. CCA is defined in paragraph 8.3 of the guidelines in the following manner:

“A CCA is a framework agreed among business enterprises to share the costs and risks of developing, producing or obtaining assets, services, or rights, and to determine the nature and extent of the interests of each participant in those assets, services, or rights. A CCA is a contractual arrangement rather than necessarily a distinct juridical entity or permanent establishment of all the participants. In a CCA, each participant’s proportionate share of the overall contributions to the arrangement will be consistent with the participant’s proportionate share of the overall expected benefits to be received under the arrangement, bearing in mind that transfer pricing is not an exact science. Further, each participant in a CCA would be

entitled to exploit its interest in the CCA separately as an effective owner thereof and not as a licensee, and so without paying a royalty or other consideration to any party for that interest. Conversely, any other party would be required to provide a participant proper consideration (*e.g.* a royalty), for exploiting some or all of that participant's interest. "

CCA is frequently being used in an arrangement for the joint development of intangible property, where each participant receives a share of rights in the developed property. In such a CCA, each participant is accorded separate rights to exploit the intangible property. A participant uses the intangible property for its own purposes rather than in a joint activity with other participants. The separate rights obtained may constitute actual legal ownership; alternatively, it may be that only one of the participants is the legal owner of the property, but economically all the participants are co-owners. In cases where a participant has an effective ownership interest in any property developed by the CCA and the contributions are in the appropriate proportions, there is no need for a royalty payment or other consideration for use of the developed property consistent with the interest that the participant has acquired. [43]

In cost contribution arrangement legal and beneficial ownership is contractually agreed and difficult ownership problems don't arise in a similar manner than in a situation where "dual ownership" is not contractually agreed. Paragraphs 6.36-6.38 of the guidelines discuss this dual ownership problem where dual ownership is not defined by contract. The problem concerns especially trademark and it may arise when significant marketing activities are taken by an enterprise that is not the legal owner of the trademark or trade name that they are promoting. The tricky question is; how the licensee should be compensated for its contributions and also how the income attributable to the marketing activities can be identified. Guidelines argue that this analysis requires an assessment of the relationship between the licensor and the licensee. If the licensee acts merely as an agent or distributor the economic ownership stays with the legal one. In the case that the licensee bears the cost and risk of its marketing activities, possible split of benefits should be considered. The OECD states that the arm's length principle should be applied for this assessment as well. Hence, it should be considered how independent distributor would be compensated from such activities. [44]

[43] Paragraph 8.6
[44] Paragraph 6.36-6.38

### 3.3. Previous discussion challenges the legal ownership

#### 3.3.1. Legal ownership v. economic ownership

Intangible assets have been long seen as a major source of profit shifting opportunities in multinational enterprises due to a highly non-transparent transfer pricing processes. MNEs have had an incentive to locate intangible property at affiliates with a relatively low corporate tax rate and, hence, MNEs have been using intangible assets for tax planning purposes [45]. This type of strategic planning for intangible assets may have a significant effect on company's worldwide tax rate and this can be achieved without any major physical movement of the operating activities. Therefore the OECD transfer pricing model seeks to allocate the profits not to the actual physical location of the asset, but rather to the business entity that is responsible for the economic risk of the relevant activities. [46] This refers shifting the target to economic ownership instead of pure legal ownership. If the legal owner would be the only receiver of the benefits attributable to the property, tax planning for intangible assets would be rather simple. In such situation MNEs could transfer all the legal rights of their intangible assets to low-tax rate countries. Therefore rather than examining the legal ownership and the physical location of intangible asset's legal rights the question in transfer pricing should be; who is entitled to the benefits arising from the intangible asset? [47]

The OECD's Working Party No. 6 is expected to commit itself to the question presented above; who actually is entitled to the benefits from an intangible asset? In transfer pricing discussion after determining to whom the legal rights of an asset belong, the ownership of an asset in broad perspective comes into the question. This is an essential matter in order to decide to whom the profits from the exploitation of the asset should be allocated. The most crucial question is to remember that the legal ownership and the economic ownership of an intangible asset may lie in different hands. [48] By nature intangible assets are non-rivalry. Therefore multiple beneficiaries may enjoy simultaneously economic benefits from rights embedded in the intangible assets. The benefits of an intangible asset are, thus, much less limited than in the case of tangible assets. They are also much easier and cheaper to extent

[45] Dischienger, M & Riedel, N, 2011, 691
[46] Abdallah, W & Murtuza, A, 2006, 7
[47] Verlinden et al. 2005, 116-118
[48] Henshall, J, 2010, 2

and divide. Due to these special characteristics of intangible assets, the question of economic ownership is more problematic with intangibles than with tangible assets. [49]

Transfer pricing discussion is currently dominated by two types of ownerships; legal ownership and economic or beneficial ownership. Legal ownership requires existence of legal title and legal protection of any intangible property. Legal ownership can be determined based on the existence of a legal right of ownership; as for example is the case with patents, copyrights or trademarks. The economic owner of an intangible asset, on the other hand, is understood to be the party that bears the costs and risks related to the intangible property. The underlying idea behind the economic ownership is that the opportunity to realize income from an intangible should reside in the same entity that also incurred the economic costs and risks related to the development of the intangible. [50]

Economic ownership may also differ from beneficial ownership. Beneficial owner refers to the party who is entitled to the profits of the asset. This can be the legal owner of the asset or some other party, as for example a licensee who is contractually entitled to the benefits arising from the asset. Economic ownership, on the other hand, is not contractually agreed. It may develop due the considerable amount of risks and actions taken by an economic owner for the success of the asset. In transfer pricing, the confrontation of the legal ownership versus the economic ownership is the most intriguing question. [51]

### 3.3.2. How development choices affect ownership

Previous research on intangibles' transfer pricing has studied widely how development arrangements made for intangible asset affect ownership of the asset. Two main development arrangements are an independent development and a joint development. In independent development intangible asset is developed independently in a manner that one company bears all the risk and costs related to the development. In such situation only one company owns the legal rights for the asset and it can sell or license those rights to other group companies. The payment for the transfer of the rights can be a lump sum fee or a running royalty/license fee that is a percentage of company's some financial indicator, like revenues. The remuneration can also be a combination of these two ways. In independent development the question of legal ownership is clear and the difficulties with the economic ownership may only arise if the

[49] Brauner, Y, 2008, 89-91
[50] Przysuski et al. 2002[2] , 4
[51] Karjalainen, J & Raunio, M, 2007, 164

asset is being licensed and the licensee then performs disproportionate contributions for the asset. This generates so called dual ownership problem, which is also recognized in the OECD guidelines. [52]

Another development alternative is a joint development. In the case of joint development two or more companies of MNE jointly develop and share costs and benefits related to the intangible under development. Joint development is in line with cost contribution arrangement defined in the OECD guidelines and it is acceptable arrangement in transfer pricing. In joint development legal rights and economic rights for the asset are shared among several companies. Dual ownership problem does not crop up but instead bargaining power of the companies plays a key role in joint development arrangements and it finally decides the share of costs and benefits arising from the asset. [53]

#### 3.3.3. Consequences if ownership is not properly determined

After the development of the intangible asset, and in order to avoid problems in transfer pricing audits, the next question for multinational enterprises is the determination of the economic benefits flowing from intercompany transactions involving intangible property. Transfer pricing practice, so far, has shown that if the question of ownership of an intangible property has not been properly assessed, there is a risk that the licensee is making incorrect payments for the use of intellectual property. This, in turn, can lead to difficulties in transfer pricing audits. [54]

Often in transfer pricing, and in business in general, it is assumed that a legal owner of an intangible property is entitled to all benefits arising from the property and, thus, the owner should be compensated by the other group members that use and benefit from that intangible property. While generally legal ownership is a good place to start is not always the case. Legal ownership is a good place to start the evaluation of profits sharing because the causality of the payment is the ability of the legal IP owner to prevent other parties using the property. Thus, the license payment is for non-exercise of that right and the amount of the payment is a fraction of the value that the licensee expects from use of the intangible property. [55]

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[52] Boos, M, 2003, 42
[53] Boos, M, 2003, 43
[54] Henshall, J & Virto, E, 2009, 1
[55] Henshall, J & Virto, E, 2009, 1

Transfer pricing practice and case law has shown that when the actions of a licensee are disproportionate to the right received under the license, the licensee can develop economic ownership of the intangible property. These kinds of situations are for example where the licensee performs abnormal marketing activities and/or bears costs and risks related to these activities, the economic ownership should be split between the legal owner of the IP and the licensee[56]. Whether the licensee has incremented the value of the trademark or trade name should also be considered. The comparison should be made at arm's length, how independent entities would have been compensated from similar activities.[57] In cases where a distributor is entitled to have a compensation of its abnormal marketing activities it can be achieved by a reduction in normal royalty payments or price paid for the products being distributed. [58]

Intangible assets that most commonly cause problems in determining the economic ownership of an asset in transfer pricing are the marketing intangibles. Marketing intangibles are assets that help in the commercial exploitation of a product or service or they have promotional value for the product[59] but despite the definition it is not always obvious what are the key value drivers of a product. In order to allocate profits arising from an intangible asset it is essential to understand what creates the value and how it is created. As marketing intangibles are used in commercial exploitation, profits allocation is an especially relevant question with marketing intangibles. Some very high profile transfer pricing audits have been focused on examining the relative contributions of various activities that drive brand value. When more than one entity is creating value for a product, it is necessary to examine the relative contributions that R&D and advertising make in generating and improving value of a product in order to split the profits in correct manner. However, it is to be noted that key value drivers vary between industries and thus industry and company specific analysis is required. [60]

# 4. Valuation

## 4.1. The arm's length principle guides valuation in transfer pricing

Regarding the valuation of intangible assets, the most important chapters in the OECD transfer pricing guidelines are chapters covering the arm's length principle, the comparability

[56] Australian Taxation Office, 2005
[57] Australian Taxation Office, 2005
[58] Paragraph 6.38
[59] Paragraph 6.4
[60] Henshall, J and Smith, G, 2009, 1-3

analysis that forms a part of the arm's length principle, transfer pricing methods and special considerations for intangible property. Principal content of these chapters is discussed next.

### 4.1.1. The arm's length principle

The arm's length principle is the international standard that OECD member countries have agreed should be used for determining transfer prices for tax purposes. Paragraph 1 of Article 9 of the OECD Model Tax Convention defines the arm's length principle:

"[Where] conditions 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 profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly."

The cornerstone of the arm's length principle is that related party transactions are being compared to transactions that do or would occur between unrelated parties. Thus the arm's length principle's objective is to adjust profits to the same level than independent enterprises would have obtained in comparable uncontrolled transactions.

### 4.1.2. Comparability analysis

Comparability analysis forms a part of application of the arm's length principle. Definition of comparison means examining two terms: the controlled transaction under review and the uncontrolled transaction that is regarded as potentially comparable[61]. Application of the arm's length principle is generally based on a comparison of the conditions in a controlled transaction with the conditions in transactions between independent enterprises. Economically relevant characteristics of the transactions being compared must be sufficiently comparable in order for the comparison to be successful. Comparability means that none of the differences between transactions being compared could materially affect the condition being examined in the methodology or that reasonably accurate adjustments can be made to eliminate the effect of any such differences. Where the degree of comparability and required adjustments are determined, an understanding of how independent enterprises evaluate potential transactions is essential. [62]

[61] Paragraph 3.1
[62] Paragraph 1.33

Independent enterprises, when evaluating the terms of a potential transaction, will compare those terms to other available options. Independent enterprise will only enter into the transaction if they see no other more attractive alternative. This business perspective is relevant question in comparability analysis because independent enterprises would normally take into account any economically relevant differences (like risk of the transaction) between the options available to them. Hence, in the application of the arm's length principle and the comparability analysis, tax administrations should consider these differences when establishing whether there is comparability between the transactions being compared and what adjustments can be applied. [63]

In the comparability analysis the assessment should be made based on the factors that independent companies would assess when choosing between different alternatives. Comparability factors that may be important when deciding the degree of comparability and necessary adjustments are the characteristics of the property transferred, the functions performed by the parties, the contractual terms, the economic circumstances of the parties and the business strategies pursued by the parties. The determination which of these factors has more emphasis in each comparability analysis depends on the nature of the controlled transaction and the pricing method. [64]

The search for comparable transactions is only a part of the comparability analysis. Before the comparables search, the analysis includes the examination of the controlled transaction and what are the characteristic factors of the transaction. The comparability analysis process includes choosing; time period to be covered, broad-based analysis of the taxpayer's circumstances, functional analysis of the controlled transaction under examination, search for internal or external comparables, selection of the transfer pricing method and assessment of the characteristics of the method and finally identification of comparable transactions and possible adjustments that are required. [65]

### 4.1.3. Transfer pricing methods

#### 4.1.3.1. Selection of the method

The arm's length principle and the comparability analysis form a base for the selection of the right transfer pricing method. The OECD transfer pricing guidelines recognize five transfer

[63] Paragraph 1.34
[64] Paragraph 1.35-1.37
[65] Paragraph 3.1, 3.4

pricing methods. However, multinational enterprises retain freedom to apply other methods when they satisfy the arm's length principle better than the methods presented in the guidelines.

The five transfer pricing methods that the OECD describes are the comparable uncontrolled price method (CUP method), the resale price method, the cost plus method, the transactional net margin method and the transactional profit split method. The three first ones are traditional transaction methods and the two last ones are transactional profit methods. The selection of the most appropriate transfer pricing method should always be done for each case in particular. The emphasis should be on the nature of the controlled transaction, the availability of reliable information about comparables needed to apply selected method or methods, the degree of comparability between controlled and uncontrolled transactions, including the reliability of comparability adjustments that may be needed to eliminate material differences. [66]

Traditional transaction methods are considered to be more direct than transactional profit methods and, thus, traditional transaction methods are more preferable, whenever applicable, than transactional profit methods. From all the transfer pricing methods the CUP method is the most preferable whenever the situation enables it. However there are situations in which transactional profit methods are considered to be more appropriate than traditional methods. This could be the case, for example, with unique and highly valuable intangible assets where two-parties make valuable contributions in relation to the controlled transactions. In such situations two-sided transactional profit split method is considered to be more appropriate than one-sided methods. Also when there is no available information on comparable transactions, transactional profit method may be more appropriate. [67]

The selection of a transfer pricing method always aims at finding the most appropriate method for a particular case. This, however, does not mean that in order to select the most appropriate method, all transfer pricing methods should be tested and analysed in depth in each case. As a matter of good practice, the selection of the most appropriate method and possible comparables should be evidenced and can be part of a typical search process performed in comparability analysis. It is also possible, for difficult cases, where no approach is conclusive, to use more than one method. In such cases, however, attempt should be made to reach a

[66] Paragraph 2.1-2.2, 2.9
[67] Paragraph 2.3-2.4

conclusion consistent with the arm's length principle that takes into account practical viewpoint of all the parties involved, special characters of the case, available information and reliability of the various methods under consideration. [68]

#### 4.1.3.2. Comparable uncontrolled price method

Paragraph 2.13 and 2.14 of the OECD guidelines define the CUP method:

"The CUP method compares the price charged for property or services transferred in a controlled transaction to the price charged for property or service in a comparable uncontrolled transaction in comparable circumstances. An uncontrolled transaction is comparable to a controlled transaction for purposes of the CUP method if one of two conditions is met: a) none of the differences (if any) between the transactions being compared or between the enterprises undertaking those transactions could materially affect the price in the open market; or, b) reasonably accurate adjustments can be made to eliminate the material effects of such differences."

When it is possible to use comparable uncontrolled transaction method, the comparable uncontrolled price method is the most direct and reliable way to apply the arm's length principle. Hence, in such cases, as already mentioned above, the CUP method is preferable over all other transfer pricing methods. However it is also acknowledged that in some cases it may be difficult to find a transaction between independent enterprises that is similar enough to a controlled transaction. This is especially the case with transactions involving intangible property because such property may have a special character and therefore comparable transactions can be difficult to locate. Associated enterprises may also enter into transactions or structure the transaction in a manner that independent enterprises would not undertake. [69]

#### 4.1.3.3. Resale price method

Second traditional transaction method is the resale price method. Paragraph 2.21 describes it:

"The resale price method begins with the price at which a product that has been purchased from an associated enterprise is resold to an independent enterprise. This price is then reduced by an appropriate gross margin on this price representing the amount out of which the reseller would seek to cover its selling and other operating expenses and, in the light of the functions performed (taking into account assets used and risks assumed), make an appropriate profit.

[68] Paragraph 2,2 2.8, 2.11
[69] Paragraph 2.14, 6.13

What is left after subtracting the gross margin can be regarded, after adjustment for other costs associated with the purchase of the product as an arm's length price for the original transfer of property between the associated enterprises."

The resale price method is probably the most useful when it is applied to marketing operations. The method assumes that the reseller does not add much value to the product. Thus in such cases where the resellers contribute significantly to the creation or maintenance of an intangible property or valuable and unique intangibles are involved, the resale price method may not be an appropriate method. [70]

#### 4.1.3.4. Cost plus method

The cost plus method is the third traditional transaction method. Paragraph 2.39 explains it:

"The cost plus method begins with the costs incurred by the supplier of property (or services) in a controlled transaction for property transferred or services provided to an associated purchaser. An appropriate cost plus mark up is then added to this cost, to make an appropriate profit in light of the functions performed and the market conditions. What is arrived at after adding the cost plus mark up to the above costs may be regarded as an arm's length price of the original controlled transaction."

The cost plus method is most useful where semi-finished goods are sold between associated parties, where associated parties have concluded joint facility agreements or long-term buy-and-supply arrangements, or where the controlled transaction is the provision of services.

#### 4.1.3.5. Transactional net margin method

Transactional profit methods examine the net profits that arise from particular controlled transactions. The two methods that are generally accepted in the OECD guidelines are the transactional net margin method and the transactional profit split method.

Paragraph 2.58 describes transactional net margin profit:

"The transactional net margin method examines the net profit relative to an appropriate base (e.g. costs, sales, assets) that a taxpayer realises from a controlled transaction."

Transactional net margin method operates in a similar manner to the resale price method and the cost plus method. In order to be applied reliably, the method must be applied in a manner

[70] Paragraph 2.21, 2.29, 2.32

consistent. In particular this means that the net profit indicator of the taxpayer from the controlled transaction should be established by reference to the net profit that the same taxpayer earns in comparable uncontrolled transactions. This is so called “internal comparable”. Where this is not possible the reference should be made to the net margin that would have been earned in comparable transactions by an independent enterprise. This on the other hand is so called “external comparable”. [71]

The transactional net margin is one-side method, just like traditional transaction methods, and hence it is unlikely to be reliable if each party of the transaction makes valuable, unique contributions. In such cases transactional profit split method is generally a more appropriate method. However one-sided method may be applicable in situations where only one of the parties makes all the unique contributions. In such cases the tested party should be the less complex one. [72]

Furthermore there are cases involving intangible assets where the contributions of the parties are not unique. In cases involving so called non-unique intangibles, it may be possible to meet the comparability requirements to apply a traditional transaction method or a transactional net margin method also to intangible assets. This is because it can be expected that the comparables also use a comparable mix of non-unique intangibles. However the lack of unique and highly valuable intangible does not automatically mean that the transactional net margin method would the most appropriate method. [73]

#### 4.1.3.6. Transactional profit split method

Transactional profit split method is another transactional profit method. Unlike the other transfer pricing methods presented by the OECD, transactional profit split is a two-sided method. Paragraph 2.108 describes the method in the following manner:

“The transactional profit split method seeks to eliminate the effect on profits of special conditions made or imposed in a controlled transaction by determining the division of profits that independent enterprises would have expected to realise from engaging in the transaction or transactions. The transactional profit split method first identifies the profits to be split for the associated enterprises from the controlled transactions in which the associated enterprises are engaged. References to “profits” should be taken as applying equally to losses. It then

[71] Paragraph 2.58
[72] Paragraph 2.59
[73] Paragraph 2.60, 2.61

splits those combined profits between the associated enterprises on an economically valid basis that approximates the division of profits that would have been anticipated and reflected in an agreement made at arm's length."

The principal advantage of the profit split method is that it can be applied to transactions in which both parties make notable contributions and one-sided method wouldn't be appropriate. Thus it may be found to be the most appropriate method for intangible property involving valuable, unique intangibles and where both parties make significant contributions. In such cases the parties may wish to share the profits according to their contributions. Also in the presence of valuable and unique assets, reliable comparables information might be insufficient for applying another method. Since the transactional profit split method evaluates both parties of the transactions it is less likely that either party of the transaction will be left with an extreme and improbable profit result. However in practice the method might be difficult to apply because sufficient profit and cost information might be challenging to acquire. [74]

### 4.1.4. Special considerations for intangible property

The arm's length principle remains the principle to be followed also for intangibles' transfer pricing even though special characters of intangibles may make it difficult to apply the arm's length principle for intangibles. When using the arm's length principle for intangible property the comparability must be evaluated from the perspective of both the transferor of the property and the transferee. From the perspective of the transferor, the arm's length principle would examine the pricing at which a comparable independent enterprise would be willing to transfer the property. The transferee, on the other hand, evaluates whether a comparable independent enterprise would be willing to pay such a price for the property, depending on the value and usefulness of the intangible property to the transferee in its business. The transferee will generally be expected to pay this license fee if the benefit it reasonably expects to secure from the use of the intangibles is satisfactory having regard to other options realistically available. If the licensee will have to undertake investments or otherwise incur expenditures to use the license it has to be determined whether an independent enterprise would be prepared to pay a license fee of the given amount given the expected benefits from the additional investments and other expenditures likely to be incurred. [75]

[74] Paragraph 2.109, 2.113, 2.114
[75] Paragraph 6.13, 6.14

The usefulness of the property should be taken into account when determining comparability. An associated enterprise is not always required to pay a full amount of the intangible property in question. If the full price of the property is based on the highest or most productive use of the property and the associated enterprise, given its business operations and other relevant circumstances, only receives limited usefulness of the property, it is no required that the associated enterprise pays a full price. [76]

A transfer of intangible property may be an outright sale of the intangible property or a licensing agreement. In licensing agreement rights in respect of the intangible property are transferred to a licensee who, on the other hand, pays royalty payments to a licensor. A royalty would generally be a recurrent payment based on the licensee's output, sales or profits. [77]

The compensation for the use of intangible property may also be included in the selling price of a purchased good. This is especially the case with unfinished goods where the buyer further processes the goods. When it is assumed that the transfer price already includes the right to use for the intangible property, the country of a buyer would normally be disallowed to pay additional royalty payments. However each transaction should be evaluated in its context considering the underlying circumstances. There appears to be no general principle that could be applied except that there would be no double deduction for the provision of technology. [78]

Sometimes an enterprise may grant a license in respect of all the intangible property that it owns. This kind of a deal is called a package contract where rights to patents, trademarks, trade secrets and know-how are included in a same price. In order to verify the arm's length price, the parts of the package may need to be evaluated separately. It may also be important to take into account value of possible technical services included in the transaction, improvement to products or processes when evaluating the arm's length price.[79]

Paragraph 6.20 of the OECD guidelines describe some special factors that should be considered in transactions involving intangible property:

[76] Paragraph 6.15
[77] Paragraph 6.16
[78] Paragraph 6.17
[79] Paragraph 6.18

"In applying the arm's length principle to controlled transactions involving intangible property, some special factors relevant to comparability between the controlled and uncontrolled transactions should be considered. These factors include the expected benefits from the intangible property (possibly determined through a net present value calculation). Other factors include: any limitations on the geographic area in which rights may be exercised; export restrictions on goods produced by virtue of any rights transferred; the exclusive or non-exclusive character of any rights transferred; the capital investment (to construct new plants or to buy special machines), the start-up expenses and the development work required in the market; the possibility of sub-licensing, the licensee's distribution network, and whether the licensee has the right to participate in further developments of the property by the licensor."

Chapter VI describes in detail special considerations for intangibles' transfer pricing. The OECD gives several recommendations for a specific situation but it also highlights that since intangible assets are often unique in nature, each situation should always be evaluated separately taking into consideration special character of the asset and circumstances of the transaction.

In the case of a sale or license of intangible property, the most direct way to establish arm's length pricing, is to use the CUP method where the same owner has transferred or licensed comparable intangible property under comparable circumstances to independent enterprises. This is so called internal comparable. When the same intangible property is being transferred under comparable circumstances between third parties it is called external comparable. In cases involving valuable intangible property, an appropriate comparable may be difficult, if not impossible, to find. Hence it can be difficult to apply traditional transaction methods or the transactional net margin method. This is especially the case in transactions involving highly valuable intangibles and where both parties of the transaction make valuable contributions. In such cases the transaction normally differs largely from those made by potential competitors. Therefore, in such cases the transactional profit split method may be the most relevant transfer pricing method even though in practice it may be difficult to apply. [80]

Particularly when assessing the arm's length price of intangible property, it is to be remembered that there is not necessarily a link between costs incurred and value of the

[80] Paragraph 6.23, 6.26

property. Even though the amount, nature and incidence of the cost incurred in developing and maintaining an intangible property might be assessed in deciding the appropriate transfer price, the actual value of intangible property is not frequently measurable in relation to the costs incurred in the development and maintenance phase. One reason is that intangible assets are often developed in long-lasting R&D process. R&D budgets however are not direct measures how much money has been invested in a particular intangible asset and what the asset is worth. [81]

### 4.2. Intellectual property law defines compensation for infringements

"Valuation" in intellectual property law can be seen as the determination of an appropriate compensation in the case of infringement of intellectual property. This refers to the fact that the court needs to evaluate the value of the infringement for each party.

**Copyright:** Reasonable compensation in the case of infringement of copyright is presented in Section 57 of Chapter 7 of Copyright Act. Copyright Act states (1) that in a case of a copyright infringement, the infringer is obligated to pay a reasonable compensation for the exploitation of the right. The reasonable compensation is to be assessed separately in each case. (2) If the work is used willfully or out of negligence, the infringer shall, in addition to compensation, pay damages for any other loss, including mental suffering and other detriment.

**Patent:** Section 58 of Chapter 9 of Patents Act describes that in a case of an infringement a person who intentionally or negligently has infringed a patent shall be liable to pay reasonable compensation for the exploitation of the invention and damages for other injury caused by the infringement. In the case of slight negligence, the compensation may be adjusted accordingly. Each case is to be assessed separately.

**Trademark:** Compensation for infringement of trademark is discussed in section 38 of Trade Marks Act. It states that if the infringement is deliberate or due to negligence, the infringed party shall be entitled to compensation from the infringer for all the damage he has suffered. If the negligence has only been slight, the court may modify the compensation awarded at its discretion. Premeditation of infringement however is not required in order to be liable to pay compensation.

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[81] Paragraph 6.27

If reasonable compensation for infringement cannot be clearly justified, section 6 of Chapter 17 of Finnish Code of Judicial Procedure allows the court to assess the reasonable compensation. In assessment emphasis should be put on the factors, which in license agreement negotiation would affect the degree of license payment. This means a value of a license and bargaining power of the parties. [82]

### 4.3. Previous discussion on valuation of intangibles is extensive

#### 4.3.1. Problems of the valuation

Valuation of intellectual property is difficult due to lack of objectivity in the valuation. No single right value or valuation method for intellectual property exists. There exist only values that are more or less justified assessments. [83] Different sources determine a meaning of fair value, value in use, recoverable amount, carrying amount or book value. International accounting standards (IAS standards) define fair value as "the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction". The reason why IFRS' definition of fair value is mentioned in this study is because the transfer pricing arena often seeks to compare fair value definition of IFRS (International Financial Accounting Standards) or FASB (U.S. Financial Accounting Standards Board) to arm's length value in transfer pricing. Transfer pricing practice, however, has recently noticed that the fair values calculated for accounting purposes may differ from the arm's length value and, thus, accounting based fair values may not be directly usable as an arm's length value in transfer pricing. [84]

The reason why transfer pricing practitioners have often turned to financial standard bodies in valuation of intangible assets is because in such case that the direct arm's length prices are not available, transfer pricing guidelines do not include specific definition on how value regarding intangible asset should be determined. As transfer pricing is an interdisciplinary question, mere accounting based valuation is not often suitable for transfer pricing purposes and the answer, therefore, needs to be searched from valuation approaches defined in business economics[85]. The three main valuation approach types that hundreds of valuation books and

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[82] Rantala, T, 2005, 301
[83] Bergström, P, 2002, 460
[84] More detailed evaluation of differences and similarities in valuing intangibles for transfer pricing and accounting purposes is out of the scope of this research but the topic is extensively covered in Finan and Work's article (2009) "Valuing intangibles for transfer pricing and accounting standards purposes: similarities and potential differences"
[85] Bergström, P, 2002, 460

studies present in area of business economics and corporate finance are the market approach, the cost approach and the income approach. These approaches are also acknowledged and widely discussed in the transfer pricing arena the transfer pricing methods accepted by the OECD are based on these type of valuation approaches. The approaches are discussed in detail further below.

The difficulty of valuation of intangible assets increases when the scope is widened to cover all types of intangible assets, and not merely legally protected intellectual property. In valuations involving so called soft intangibles, such as strong customer relationships or workforce in place, subjectivity of the valuation further increases. When the mere definition and the scoping of these assets is a debatable issue, it is reasonable that also the valuation of these assets is a rather debatable issue and the reason why the discussion of definition of intangible asset is included in this paper. [86] Intangible assets' unique, often firm-specific nature makes the difference when comparing them to other asset group. Intangible assets' role in adding value to a business is therefore rather different than tangible assets or services. [87] Intangibles are also often company's key to commercial success and, thus, they require different analysis than what is required for tangible assets[88]. Therefore valuation approaches developed for tangible assets or services may not be appropriate for intangibles. [89]

### 4.3.2. Market approach

The market approach determines the value of intangible asset by the price paid for the same intangible in comparable transactions between unrelated parties. The market approach, thus, refers to the comparable uncontrolled transaction method of the transfer pricing guidelines. In the light of the OECD guidelines the market approach is the most preferable valuation approach. However, the approach includes several difficulties that often limit its application. Firstly finding comparable market transactions between unrelated parties may become a problem, especially in the case of intangible assets that are often unique in nature. Secondly, even though comparable transactions could be detected, it is possible that sufficient public information is not available to perform the comparability analysis required in transfer pricing. [90]

[86] John Henshall, interview 2.2.2012
[87] Henshall, J, 2010, 4
[88] Abdallah, W & Maghrabi, A, 2009, 116
[89] Henshall, J, 2010, 4
[90] Boos, M, 2003, 78-81

The market approach does not calculate prices, it observes them. It has been said that it relies on the wisdom of the invisible hand. The approach is appropriate when an active and extensive market for similar transactions to the tested transaction exists. The market approach is considered to be a more reliable approach since it does not rely on subjective calculations. It is an objective approach. For transfer pricing purposes the approach is also more direct than other approaches because it examines the value or price of a property, not costs or incomes related to the property that are then indirectly used to calculate the price. The weakness of the market approach is that it is very dependent on available market information. The approach cannot be applied if sufficient market information is not available, which is often the case with intangibles. It is not enough that comparable transactions can be found; also details related to comparable transactions are needed in order to perform comparability analysis and possible adjustments. Companies, however, can be protective concerning the information of strategic transactions involving intangible assets.[91] This, in turn, leads the transfer pricing analysis to the fundamental problem of finance. If the market approach assumes that market sets the absolute right value for an asset, the market is assumed to be perfect and its practitioners perfectly informed. However, rarely in any market, especially in the market of intellectual property, does perfect market exist. Hence, also the superiority and applicability of the market approach in practice has been questioned. [92]

From transfer pricing methods accepted by the OECD the comparable uncontrolled price (CUP) method constitutes a market approach method[93]. The CUP method is the most direct and reliable way to apply the arm's length principle and, thus, it is the most preferred method over all other methods whenever comparable uncontrolled prices can be found[94]. The comparable uncontrolled transaction (CUT) method is a parallel method to tangibles' CUP method, adjusted for the fact that with intangibles it is unlikely to have comparable transactions with similar enough properties. Hence, the emphasis of the CUT is more on the nature of the transactions. The similarity of the transferred property is also important under the CUT, yet not that relevant or likely than with tangible property. [95] In this research the CUP or the CUT method terms don't make difference since only intangible assets are covered. Even though according to the OECD the CUP/CUT method is the preferred method, transfer

[91] Brauner, Y, 2008, 107
[92] Pitkethly, R 1997, 7
[93] Wittendorff, J, 2010, 327
[94] Paragraph 2.14
[95] Brauner, Y, 2008, 128-129

pricing practice has found that for intangible assets it is rare to find sufficient comparable transactions and thus the method is not frequently used in practice[96].

#### 4.3.3. Cost approach

The cost approach valuates intangible asset based on the values of its inputs. The approach assesses the value of an intangible asset by the cost of creating and transferring it. The approach assumes that the value of an intangible equals to its development costs and thus the higher the development costs are the higher the value of an asset is. Transfer pricing practice, however, has shown, this is not often the case, particularly when it comes to intangible assets. The cost approach nevertheless is constantly under discussion in transfer pricing, perhaps because it relies on the substitution principle that do make economic sense. *The substitution principle asserts that an investor will not pay more for an investment than the costs to purchase or develop an investment of equal utility.* [97]

Several methods to measure costs under the cost approach also exist. The historic cost and the reproduction/replacement costs are the most common ones. The historic cost approach is the simplest approach. It calculates the costs of developing the intangible asset. The approach is straightforward to understand but in practice it is not that simple. The intriguing question is what costs should be included in the historic costs. For example which costs should be allocated for a specific trademark or a pharmaceutical drug, when the company has simultaneously several trademarks and drug development projects? Also a question of when the development of an intangible asset begun and ended can be tricky because intangible assets are often under constant improvement. The reproduction cost approach, on the other hand, measures what it would cost at current moment to construct the exact same asset using the same technique. The replacement cost approach measure the costs to recreate the existing functionality and utility of an intangible asset in question. In the replacement cost approach a replacement intangible may also be better than the original one and it can be constructed in a different manner. [98]

The cost approach, in general, is said to be a relatively weak approach for intangible assets' transfer pricing[99]. The fundamental assumption of the approach, the disclosed costs projecting value of an intangible asset, has been questioned. High development costs do not guarantee

[96] Herksen et al. 2008, 7
[97] Boos, M, 2003, 75
[98] Boos, M, 2003, 76-77
[99] Boos, M, 2003, 77

success of a project and at the same time valuable asset can be created at minimal cost. A classic example presented in the literature is pharmaceutical industry where projects' R&D costs are enormous. Despite of huge R&D costs used for an invention of a specific product, the product might never be developed till marketable product. On the other hand, some successful products might have been discovered as a byproduct of some other project and thus the R&D costs attributable to the product might be almost non-existents. Practical problem, on the other hand, is the choice of costs attributable to one specific intangible. [100] Previous academic literature regarding valuation of intangible assets agrees on inadequacy of the cost approach to valuate intangible assets. It is, however, still widely used because it is relatively easily understandable and applicable, it often fits with tangible assets and other alternative approaches might be difficult to apply.

From the transfer pricing methods accepted by the OECD the cost plus method is a cost approach based method[101]. Transfer price under this method is computed by calculating the cost of producing the intangible asset and then it is added an appropriate gross profit. The appropriate gross margin may be determined from comparable uncontrolled sales of the seller or between unrelated parties. The problem of the cost plus method is that it is one-sided method and it takes into account only the profit mark-up of the seller. Thus the method tends to underestimate the transfer price because it gives all non-routine and unallocated profits to the buyer. [102] This is said to be especially problematic in transactions involving intangible assets because intangibles often create non-routine profits. The cost plus method is fairly unusual in the practice of intangible assets' transfer pricing. The reason is its inaptitude for intangible assets and the fact that costs incurred in the development of the product rarely project the value of the intangible.

### 4.3.4. Income approach

#### 4.3.4.1. Income-based methods

The income approach measures the value of an intangible by the estimated value of future economic benefits it may generate over its expected remaining lifetime[103]. The value can be calculated at any time by discounting the future benefits to present value. Under the income approach successful valuation requires reliable projection of the future income stream,

[100] Brauner, Y, 2008, 110-114
[101] Wittendorff, J, 2010, 327
[102] Abdallah, W & Murtuza, A, 2006, 12
[103] Boos, M, 2003, 81

duration of the stream, terminal value and the risk attributable to its generation. [104] Influence of these factors and different methods used in determining future income streams are discussed next. Academic literature includes various income-based valuation methods for intangibles and, since, the OECD transfer pricing guidelines do not prohibit the use of methods other than the ones mentioned in the guidelines, transfer pricing practice recognizes several income-based methods. [105]

The most straightforward way to estimate future income stream deriving from an intangible assets is to ask what the owner of the IP would pay in royalty if it did not own the IP and had to license it from third party. This is called "relief from royalty approach". The approach valuates savings that the holder receives by owning the assets and not paying royalty fees. The value arrived at under this method is equal to the present value of the royalty stream that the business saves by owning the asset. The problem of the method is that it again requires market-based analysis on royalty rates, which on the other hand might not be available. [106]

Another income based valuation method used in transfer pricing practice is "excess earnings approach". It values the additional profits that accrue to the enterprise that owns the IP over and above those generated by similar enterprises that do not have the particular asset. Possible ways to measure excess earnings could be done by comparing profit margin differential or comparing the return on capital employed by the enterprise owning the IP with that earned by non-owner companies. The excess earnings that the assets expected to generate would then be discounted to present values. The problem of the approach, in turn, is to determine the excess earnings attributable to a particular intangible asset. [107]

From the transfer pricing methods accepted by the OECD the transactional net margin method (TNMM) and profit split method are income-based methods[108]. The idea of the TNMM is to evaluate the transfer price charged based on objective measures of profitability derived from market transactions of similar business activities in similar circumstances. But since intangibles are inherently unique in many cases and companies' data regarding intangibles is not often available and the TNMM method ignores the unique characteristics of intangible

[104] Brauner, Y, 2008, 114
[105] Verlinden et al. 2005, 65
[106] Verlinden et al. 2005, 66
[107] Verlinden et al. 2005, 66
[108] Wittendorff, J, 2010, 327

assets and it might not be an appropriate method for intangible assets.[109] Such situations rather require profit split method.

Taking into consideration the criticism of other transfer pricing methods, researchers and practitioners of transfer pricing agree that in most cases the profit split method is the most appropriate method for valuable, non-routine intangible assets. In the case of valuable, non-routine intangibles, the methods based on independent comparables may not be reliable[110]. The transactional profit split method tests whether the allocation of combined profits between related parties is at arm's length[111]. As the OECD's guidelines state the principal advantage of the profit split method, compared to other methods, is that it can be applied to transactions in which both parties make notable contributions and one-side method wouldn't be appropriate. It considers the perspective of both parties and it is based on actual profits, not projected ones. [112]

Two kinds of profit split approaches that transfer pricing practice widely applies are the comparable profit split and the residual profit split[113]. Comparable profit split simply observes the percentages of profit allocated between unrelated parties and applies the same percentage to the transactions between related parties. If differences between controlled and uncontrolled transactions exist but they are not material, adjustments can be made in the division of profits. [114] A reliable application of comparable profit split requires a high level of comparability between the controlled and the uncontrolled transactions. Strict functional or product similarity, however, is not required. Comparability in factor, capital markets and contractual relationship is more relevant. [115] The main advantage of the comparable profit split method is that it identifies an arm's length remuneration for individual intangible asset. Thus the arm's length character of intercompany royalty rates for specific intangible can be tested based on third-party data of comparable royalty agreements. This method is regularly used in the pharmaceutical industry. [116]

[109] Wittendorff, J, 2010, 327
[110] Miesel et al. 2003, 20
[111] Brauner, Y, 2008, 130-132
[112] Wittendorff, J, 2010, 335
[113] Brauner, Y, 2008, 132
[114] Brauner, Y, 2008, 130-133
[115] Miesel et al. 2003, 20
[116] Vögele et al. 2006, 2

The most commonly used method for intangible assets is, however, the residual profit split[117]. It gives contrast for standard transfer pricing methods that usually put too much attention on routine function. The method has two steps. First step identifies the profit attributable to a specific intangible asset and the second step divides them. The residual profit split divides company's profits into two; profits attributable to routine functions and the residual profit. Firstly the routine profits are shared to the providers of routine functions in order to assign an arm's length remuneration for them. Subsequently the residual profit is divided between the parties according to their contributions in residual profit generation of a certain intangible asset. [118]

From the transfer pricing methods recognized in the OECD guidelines, transactional profit methods represent the income approach, the CUP method represents the market approach and the cost plus method refers to the cost approach. The resale price method does not belong solely under one approach. In practice the resale price method is being frequently applied where tangible assets are bought and then resold without adding substantial value to the property by the reseller. Due to the nature of intangible assets the resale method is not very suitable for intangibles and thus it is not commonly used in practice with transactions involving intangible property. [119]

#### 4.3.4.2. Applicability of the approach

The methods discussed above and the income approach in general, has also its shortcomings. Firstly the income approach might not be suitable for all types of intangibles. The approach not only seeks to measure the direct income stream of a product but rather it wishes to measure all the economic benefits attributable to the asset. The problem is that some intangibles do not generate a distinct, separate income stream but rather improve an income stream of some other asset or the company in general. Thus, defining the income stream attributable to a certain intangible asset may be difficult. Another difficulty relates directly to transfer pricing. Transfer pricing usually takes place in an early stage of the intangible assets exploitation. In an early stage the estimations of future benefits must rely on relatively uncertain projections with very little information on the income generated by such asset. This is particularly a problem with intangible assets that do not have existing markets. Typically

[117] Herksen et al. 2008, 7
[118] Vögele et al. 2006, 1
[119] Herksen et al. 2008, 7

valuations are in a context of market transactions in existing assets, assets that are ready for exploitation. This is not the case with intangibles. [120]

Another shortcoming of the income based method is that they often rely on rules of thumbs and industry estimations to establish an appropriate royalty rate or profit margin, which exposes it to all the difficulties that the market approach faces or the obvious inaccuracy of rules of thumb. [121] The use of rules of thumbs is already rather questionable in the transfer pricing arena because as a consequence of court case (Uniloc USA, Inc. et al v. Microsoft Corporation) evidence based on rules of thumbs no longer holds no evidential value before US Court[122]. This topic will be further discussed further on.

Same problem as with the income stream, is with the timing and risk associated with the project. The determination of time is especially difficult with intangible assets since the uniqueness of intangibles makes analogies to economic life of similar assets problematic. Intangible assets are also present in areas that are under constant change and the pace of the change is increasing all the time. Of course for some intangible assets, like the ones protected by certain years of patent, timing is more eas to define. [123] The determination of risk and appropriate discount rate associated with intangible assets, in turn, is equally difficult for transfer pricing purposes than for corporate finance purposes. The assessment of risk requires subjective judgment, expertise and possibly a variety of optional models. [124]

Furthermore the concept of terminal value of an intangible asset is rather questionable in transfer pricing. It is however an extremely relevant question because it has major effects on asset valuation. Terminal value relates to economic life of the asset being evaluated. Corporate finance world generally relies on going concern –principle and therefore assumes perpetuity growth rate in determining terminal value of an asset. This however may not be the correct approach in the context of transfer pricing valuations where the intangible assets' useful economic lives should be recognized as limited to a specific number of years. The economic life should be determined by an analysis of the specific facts and circumstances. [125]

[120] Wittendorf, J, 2010[2], 401
[121] Brauner, Y, 2008, 119
[122] Henshall, J & Reams, K, 2011, 1
[123] Brauner, Y (2008), 119-120
[124] Brauner, Y (2008), 119-120
[125] William, F & Finan, S, 2011, 5

The income approach is subjective and sensitive to the accuracy of the estimates. The parameters of the calculations might be difficult to estimate and the results depend largely on the selected parameters. However, despite the difficulties, the income approach is often considered to be the most appropriate approach for transfer pricing purposes. The approach is more imminent with value than other approaches and ultimately income is the basis for taxation in our income tax system. The approach gives better reality perception than the cost approach, and market information needed for the market approach is rarely available. The income approach is definitely the most used approach in the practice of transfer pricing due to the relatively available and relatively accurate data. [126]

### 4.3.5. Combination of the approaches

All things considered it can be concluded that all of the approaches have shortcomings when it comes to the valuation of intangibles. Only market forces, which intangibles are often missing, can discover the true value of an asset because the asset is worth only what the highest bidder in the market is willing to pay.[127] In theory in perfect market if the economic benefits generated by an intangible asset and the development costs of the asset would be linked, all the approaches would give the same result. But as discussed above, due to the nature of intangibles, the economic benefits arising from the intangible asset rarely interrelate with the production costs of the asset, and thus different approaches give different values. The uniqueness of intangible asset means that they are not easily reproducible and value chains cannot be easily traced. [128]

There is no one best solution for choosing the right approach. However under the current transfer pricing guidelines the question should be: Which of the approaches under current conditions and in its context are the most appropriate methods to calculate the fair market value for intangible asset? The answer again is a disputable topic among transfer pricing specialists. Parties in favor of the market approach argue that the market approach should be preferred because of its arm's length quality and objectivity. The advantage of the market approach compared to other approaches is specially the objectivity. But since the market approach is often not available due to the lack of comparable transactions, some appraisers tend to prefer the income approach to be the best method. Defenders of the income approach argue that it is the most appropriate approach because it is future-oriented and thus

[126] Brauner, Y, 2008, 120
[127] Hulten, C & Hao, X, 2008, 1-3
[128] Boos, M, 2003, 87

corresponds well to the nature of intangibles that is the uniqueness and the future-profit orientation. It is also said to be the perspective of what an investor assumes when buying an intangible. However, also a combination of the market approach and the income approach is possible whenever external market transfers exist. The cost approach is not recommendable to use due to the fundamental incorrectness discussed above. [129]

#### 4.3.6. Lifecycle influence on value

In determining value of an intangible asset under any approach, lifecycle phase of the asset has crucial meaning. This is because value of an intellectual property and economic life of a property are in a close relationship[130]. Economic life could be describes as a time period when economic benefits deriving from an asset are received. Economic life is different than useful life or legal life. Legal life may restrict the economic life. Useful life, on the other hand, is shorter of these two. Legal life ends when validity of an intellectual property right ends. Normally also economic life runs out at the same time. This means that when calculating expected economic benefits arising from asset, no benefits after its legal life should be taken into account. [131]

Value of an intellectual property may fluctuate during the lifecycle of the property. A patent and copyright is granted for a specific period whereas a trademark has theoretically indefinite life. Value of an intellectual property with definite legal life, is generally on its greatest right in the beginning and decreases over time. Value of a trademark on the other hand, normally increases over time when the trademark creates its goodwill –value. Copyright's legal life is normally longer than its economic life, thus its useful life ends when the economic life ends. However any generalization cannot be made with copyright or other intellectual property right's useful life because they depend upon many asset- and industry-specific factors.[132]

## 5. The role of case law examples in guiding transfer pricing

### 5.1. The role of Supreme Court's precedents in Finland

After presenting the institutional background and previous discussion regarding the valuation of intangible assets the paper now moves on to present the role of case law decisions in

[129] Boos, M, 2003, 87
[130] Bergström, P, 2002, 467, Immateriaalioikeuksin arvostaminen – osa yrityksen arvonmääritystä citation from Tuominen, M (2001) Teollisoikeudet vakuutena
[131] Verlinden et al. 2005, 156-157
[132] Bergström, P, 2002, 468

guiding transfer pricing practice. Since the OECD transfer pricing guidelines, like the name says, are mere guidelines that the member countries have agreed to follow and no peremptory legislation for transfer pricing exists, transfer pricing practice and examples have an important role in guiding transfer pricing. Since the transfer pricing practice by following the arm's length principle seeks to take an example of the real world practices between third parties the intellectual property case law therefore may serve as an illustrative example in determining the direction of intangible assets' transfer pricing[133].

In Finnish judicial system, laws form a base for judicial practice. Laws, however, can be unclear or open to various interpretations. In such situations judicial practice seeks answers from the legislative history of the law. In such a case that neither law nor its legislative history includes a response to a particular question, the court has the right to interpret the law. Thus, in Finland the court is seen as a continuator of legislator's work. Since law can often be unclear or open to various interpretations, the role of the court's decisions in forming legal praxis is emphasized. Gradually the court decisions form a series of precedents and its decisions' importance in a particular matter increases. [134]

Along with the Supreme Administrative Court, the Supreme Court is the topmost court in Finland. The most important function of the Supreme Court is to rule on important points of law in cases which are significant for the entire legal order, guiding thereby the administration of justice in future cases. These precedents are usually created in cases for which the applicable Acts of Parliament and Decrees do not provide a clear solution for a question of law or in which there is room for interpretation. [135]

Under the Finnish legal system a judicial precedent is not binding. Courts of Appeal and even district courts may depart from earlier decisions made by the Supreme Court, for example when the social circumstances have considerably changed. In practice, however, precedents of the Supreme Court are followed in cases arising after the precedent has been created and involving a similar point of law. [136]

[133] Francescucci, D & Henshall, J, 2012, 1-3
[134] Lapin Yliopisto, 2011, 142-143
[135] www.kko.fi
[136] www.kko.fi

### 5.2. Case law decisions in other OECD member countries

Court decisions in other OECD member countries are not binding in Finland but it is reasonable to assume that these decisions serve as a good reference in Finland as well. WTO (World Trade Organization) member countries have agreed on the TRIPS Agreement, which sets out the minimum standards of protection of intellectual property to be provided by each member country. Member countries may, but are not obligated, to implement in their law more extensive protection than is required in the agreement. The agreement came into effect on 1 January 1995 and it is to date the most comprehensive multilateral agreement on intellectual property. The agreement states; "members desiring to reduce distortions and impediments to international trade, and taking into account the need to promote effective and adequate protection of intellectual property rights, and to ensure that measures and procedures to enforce intellectual property rights do not themselves become barriers to legitimate trade". This kind of harmonization of intellectual property legislation has led to a situation where intellectual property case law based on intellectual property legislation of different countries is often relatively easily convertible to other countries. [137]

Finland, Canada, the United States and the United Kingdom, countries mentioned in this study, are all member of the WTO and follow the TRIPS agreement. Hence, their intellectual property legislation is very alike and decision applied, for example, in the US may provide guidance on how Finnish legislation concerning same question could be interpreted. Jay-Lor v. Penta and Uniloc USA Inc. et al. v. Microsoft Corporations cases that are presented in the next section are not the only cases that have had influence on transfer pricing transactions involving intangible assets. Interested readers should also see the following cases:

Georgia-Pacific Corp. v. United States Plywood Corp. (1970), Daubert v. Merrel Dow Pharmaceuticals (1993), General Tyre & Rubber Co v. Firestone Tyre & Rubber Co Ltd. (1976), Gerber Garment Technology Inc. v. Lectra Systems Limited (1995), AlliedSignal Inc. v. Du Pont Canada Inc. (1998), Colonia Fastener Co. v. Lightning Fasteners Co. (1937), Unilever Plc. v. Procter & Gamble Inc. (1995), Meridian International Service Ltd. v. Richardson & ORS (2008), Baird Textiles Holdings Limited v. Marks and Spencer Plc. (2011).

[137] The TRIPS Agreement is Annex 1C of Marrakesh Agreement Establishing the World Trade Organization

The list is not comprehensive and it only includes cases from the US, the UK and Canada. The value of these cases for transfer pricing in Finland is that they serve as an illustrative example showing how intellectual property case law struggles with the same questions than the transfer pricing arena is confronting globally.

# 6. Case law in other OECD member countries

## 6.1. Jay-Lor International Inc. v. Penta Farm Systems Ltd.

### 6.1.1. Preview

The case was heard in Federal Court of Canada. The plaintiffs are Jay-Lor and the defendants are Penta. Both the plaintiffs and the defendants are in a business of manufacturing and selling vertical feed mixers, mainly to the agricultural market. The machine is, almost exclusively, purchased by farmers who use the vertical feed mixer to mix the components of feed for their livestock. The trial deals with patent infringement and compensation for the use.

In 2003 Jay-Lor was granted a patent '092 for the vertical feed mixer. The claim date for the patent was already in 1999 and it was laid open for public inspection in 2001. The patent was issued for the whole vertical feed mixer but in this case the most relevant part is the auger inside the drum portion of the machine. From 1995 to 2001 Penta was a dealer for Jay-Lor's vertical feed mixers. In 2001 the business relationship ended and Penta started manufacturing and selling its own vertical feed mixers. The plaintiffs argued that Penta's vertical feed mixers, especially the augers used in the mixers, infringed the patent '092. The dispute on patent infringement concerned two types of vertical feed mixer designs, original and redesigned - models. The court found that only the original design vertical feed mixer of Penta infringed the patent '092. Penta was obligated to compensate the infringement to Jay-Lor. Under Canadian legal system a patentee whose patent has been infringed may elect, as a remedy, either an accounting of profits or an award in damages. In this case the plaintiffs elected award in damages.

The defendants infringed the patent until 2005 when they stopped manufacturing and selling the original Penta vertical feed mixer. In considering the damages to be compensated, two different periods were considered; from 2001 to 2003 and from 2003 to 2005. First period comprises the time when the patent application was laid open to public inspection until the patent was granted and the second period is the infringement period after the patent was

already lawful. Under Canadian Patent Act the court decided that from the first period the plaintiffs were entitled to reasonable compensation (in this case a reasonable royalty) on all sales of infringing product made by Penta. From the second period the plaintiffs were entitled to "all damages sustained…by reason of the infringement".

Compensation for period 1;

The court decided to use the anticipated profits methodology in determining a reasonable royalty. It concluded that it gives the best "judicial estimation" over other methodologies like the AlliedSignal Approach or the analytical approach. Under the anticipated profits methodology, Penta would negotiate a reasonable royalty by estimating its anticipated profits arising from the sale of the patented invention and then paying a portion of those profits to Jay-Lor. Thus, the first step in anticipated profits methodology is to assess, as a percentage, what Penta would have anticipated as a profit once it began selling the vertical feed mixer with the patented technology. The key to the anticipated profits approach is an estimation of the anticipated economic benefits in the hands of the licensee. This means going into the hypothetical negotiations, what profit would Penta have hoped to make from the sale of the patented technology?

After carefully analyzing the special characters of the case the court decided that Penta would have anticipated a net profit of 20%. Having established the profits anticipated by Penta the court next assessed what portion of those profits or alternatively from the defendant's total sales would be paid to Jay-Lor. First the court herd expert opinions on appropriate royalty rate in similar cases and it then considered the following 13 factors in order to adjust the appropriate royalty rate; transfer of technology, differences in the practice of the invention, non-exclusive license, territorial limitations, term of the license, competitive technology, competition between licensor and licensee, demand for the product, risk, novelty of invention, compensation for R&D, displacement of business and capacity to meet market demand. After thoroughly assessing the expert opinions and the listed factors the court concluded that appropriate royalty rate to be 7 % of the defendant's sales. First period's reasonable compensation was thus 7% of the total sales revenues of the period 1.

Compensation for period 2;

Canadian Patent Act provides that plaintiffs are entitled to "all damages sustained…by reason of the infringement". The court determined that the assessment of damages on lost sales

should be made on amount and price of the vertical feed mixers sold to the customers. The court first estimated the lost profits for Period 2 based on those sales that Jay-Lor would likely have attained itself. Regarding the sales that Jay-Lor would not likely have attained itself, the court decided that reasonable compensation for those profits to be the same 7% royalty payment than in period 1. So the second period's compensation comprised two parts; Jay-Lor's lost sales on those sales expected to Jay-Lor to attain and a 7% royalty payment on those sales that Jay-Lor would have not attained itself.

### 6.1.2. Implications on transfer pricing

The review of this case demonstrates that intellectual property case law decisions ask precisely the same question that transfer pricing is asking to achieve arm's length pricing in non-arm's length situation involving the licensing of intangibles. In considering compensation in the case of infringement the case clearly answers the same question "What would be the license fee paid between a willing licensor and a willing licensee? Jay-Lor v. Penta case definitely shows that intellectual property case law is useful in illustrating acceptable and unacceptable methodologies in valuing a reasonable compensation in transfer pricing. [138]

In determining compensation for the period 1 the court's primary objective was to set the reasonable compensation at the level that was commonly used in patent right licensing in the industry. However as sufficiently comparable licensing transactions didn't exist in the market, the court assessed the reasonable royalty based on "hypothetical negotiation". Hypothetical negotiation means how the royalty rate would have been negotiated under market circumstances (without infringement). The court stated; "evidence of how parties negotiate license agreements and the theory applicable to the negotiations is available. In other words, from studying what is happening in the real world of licensing practices and applying generally-accepted methodology to the known facts in a specific case, we can form an opinion as to what would have happened in hypothetical negotiations between the parties in this case."

In transfer pricing terms the reasoning of the court to reach reasonable compensation refers to the market approach and the CUT/CUT -method. First the court looked for "comparable transaction" meaning the pre-existing royalty rates in the market. As sufficient "comparability" level between other licensing agreements in the market was not sufficient, the court turned to hypothetical negotiation, which has features of the market approach and

[138] Francescucci, D & Henshall, J, 2012, 1

the income approach.[139]

In determining the reasonable compensation the court ended up using the anticipated profits method. In the anticipated profits method the likely profit from exploitation of the IP is first ascertained, split between the licensee and the licensor and then expressed as a percentage of turnover to calculate a royalty. The method is completely consistent with profit split method accepted by the OECD. Furthermore the use of anticipated profits makes economic sense to transfer pricing experts, as it is necessary to view the transaction from the viewpoint of both the licensor and the licensee. Furthermore in arm's length situations, the licensee often needs to make investments to exploit the intellectual property and so it must determine before entering into the license that it will return a profit. Thus, in arm's length negotiations, the licensee will prepare a forecast of expected profits from the use of the intellectual property and the forecast influences the negotiations with the potential licensor. [140]

After hearing expert opinions on reasonable royalty rate, the court considered a 13 factor list in order to decide the relevant profit split between the parties. The 13 factors were; transfer of technology, differences in the practice of the invention, non-exclusive license, territorial limitations, term of the license, competitive technology, competition between licensor and licensee, demand for the product, risk, novelty of invention, compensation for R&D, displacement of business and capacity to meet market demand. All these factors determine how readily usable the property is in hands of the licensee, does it bring exclusive rights or is it possibly territorial limited, what kind of risks and terms it includes, how is the competition and can the property be displaced easily. These factors are rather consistent with paragraphs 6.20-6.22 of the OECD guidelines that list the factors to be taking into account in setting royalty rates for related parties. The list used by the Canadian Court is also pretty similar as the ones used in courts in the USA and the UK. However it is important to take into consideration specific characteristics of each case so that one takes into account all factors that would reasonably be taken into account by a willing licensor and a willing licensee. [141]

Besides showing what is an appropriate approach to determine compensation in a transfer of an intangible assets, Jay-Lor v. Penta case's main offering for transfer pricing is to prove that

[139] Francescucci, D & Henshall, J, 2012, 1-4
[140] Francescucci, D & Henshall, J, 2012, 1-4
[141] Francescucci, D & Henshall, J, 2012, 1-4

intellectual property case law confronts exactly the same question than related party transactions are facing. [142]

## 6.2. Uniloc USA Inc. et al. v Microsoft Corporation

### 6.2.1. Preview

The case was heard in the United States Court of Appeals for the Federal Circuit. The plaintiff is Uniloc and the defendant is Microsoft Corporation. The case deals with patent infringement and compensation for damages. Uniloc is an owner of the patent '216 that is directed to a software registration system to defer copying of software. Uniloc claimed that Microsoft's Product Activation System, used on Microsoft software programs such as Word XP, Word 2003 and Windows XP software, infringed its patent. The US Court of Appeals for the Federal Circuit found that Microsoft infringed the patent. The most significant statement of the Court, however, relates to damage claims because the Court decided that the 25 percent rule of thumb used to estimate a fair royalty was "fundamentally flawed" and it no more held any evidential value before a US court.

The plaintiffs had applied so called "25 percent rule of thumb" in determining the damage claims. "25 percent rule of thumb" hypothesizes that 25% of the value of the product would go to the patent owner and the other 75% would remain with the licensee. The plaintiffs justified the use of rule of thumb because it has "been accepted by Courts as an appropriate methodology in determining damages". The plaintiffs had then considered several of the *Georgia Pacific* factors [143], with the idea of adjusting the 25 % up or down.

Already the district court noted that "the concept of a 'rule of thumb' is perplexing in an area of the law where reliability and precision are deemed paramount." The district court, however, allowed the use of rule of thumb because the rule had been widely accepted. The Court of Appeals later reversed the decision.

Under the US law in the case of a patent infringement damages shall "in no event [be] less than a reasonable royalty for the use made of the invention by the infringer, together with interest and costs as fixed by the court." In litigation, a reasonable royalty is often determined on the basis of a hypothetical negotiation, occurring between the parties at the time that infringement began. The court concluded that a reasonable royalty is the predominant

[142] Francescucci, D & Henshall, J, 2012, 1-4
[143] See Georgia-Pacific Corp. v. United States Plywood Corp

measure of damages in patent infringement cases. The 25 percent rule thumb is a tool that has been used to approximate the reasonable royalty rate that the licensee would be willing to pay to the patentee during a hypothetical negotiation. The rule suggests that the licensee pays a royalty rate equivalent to 25 percent of its expected profits for the product that incorporates the intellectual property at issue. The underlying idea is that the licensee retains a majority 75% of the profits because it has undertaken substantial activities and risks when developing and commercializing the product.

The court observed that the origin of the rule was a single study that observed commercial licenses entered into by a "Swiss subsidiary of a large American company, with 18 licensees around the world, each having an exclusive territory". Afterwards lower courts have invariably admitted evidence based on the 25% rule, largely due to its widespread acceptance or because its admissibility was uncontested. The admissibility of the rule had never been squarely presented to the court. The 25 percent rule has, however, countered harsh criticism that could be separated into three factors; (1) firstly the rule fails to account for the unique relationship between the patent and the accused product. It is claimed not to take into account the importance of the patent in profit generation of a particular product. The court discussed that for narrow patents, the rule may be overly generous to the patentee and for broad patents it may be overly stingy. (2) Secondly, the rule fails to account for the unique relationship between the parties. It does not consider the context, the negotiation power of the parties or the risk assumed by the licensor and the licensee. (3) Thirdly, the rule is essentially arbitrary and does not fit within the model of the hypothetical negotiation within which it is based.

Based on these criticisms and the fact that there was no scientific base behind the rule the court sentenced:

"This court now holds as a matter of Federal Circuit law that the 25 percent rule of thumb is a fundamentally flawed tool for determining a baseline royalty rate in a hypothetical negotiation. Evidence relying on the 25 percent rule of thumb is thus inadmissible under *Daubert* and the Federal Rules of Evidence, because it fails to tie a reasonable royalty base to the facts of the case at issue."

The court continued arguing that there always must be a basis in fact to associate the royalty rates used in previous licenses to the particular hypothetical negotiation at issue in each case. The 25 percent rule of thumb as an abstract and largely theoretical construct fails to satisfy

this fundamental requirement. The rule does not take into account a particular hypothetical negotiation or special characteristics of the parties or the property involved. Relying on the 25 percent rule of thumb in a reasonable royalty calculation is far more unreliable and irrelevant than reliance on parties' unrelated licenses. The court furthermore specifies that even though the rule of thumb would be merely used as a starting point in estimating a reasonable royalty rate and which then would be adjusted by the *Georgia-Pacific* factors, the use of the rule hold no evidential value. Beginning from a fundamentally flawed premise and adjusting it based on legitimate considerations specific to the facts of the case nevertheless results in a fundamentally flawed conclusion.

The court further notes that the court's rejection of the 25 percent rule of thumb is not intended to limit the application of any of the *Georgia-Pacific* factors. For readers to be aware, the *Georgia-Pacific* factor list is a similar kind of list as presented in Canada's Jay-Lor and Penta case. It is a list of factors that should be considered when determining a reasonable royalty. The *Georgia-Pacific* factor list is developed in the US Court, it has 15 factors and it is rather similar than the 13 factor list adopted by Canadian Court [144]. Also courts in the UK have their own lists. However as already discussed in Jay-Lor v. Penta case relevant factors of each list are to be considered in the context of each case.

### 6.2.2. Implications on transfer pricing

The obvious conclusion of the case is that the "25 percent rule" no longer applies to any transfer pricing of intangible assets, which includes a US licensee or licensor. Nevertheless the rejection of the 25 percent rule of thumb in the US may have significant implications also on intangible assets' transfer pricing in other countries. Even though the US Court's decision is not binding in any other jurisdiction, the decision could also prove valuable in contending before a Court in another jurisdiction, or before a tax court, that the "25 percent rule" has no place in the transfer pricing of intangibles. [145]

Besides showing that the rule of thumb used also in transfer pricing was rejected in intellectual property case law, another important learning of this case for transfer pricing is the court's willingness to apply arm's length pricing. The fundamental idea of the arm's length principle is to determine what the related parties would have done had they not been related; that is, what price would be negotiated by independent, unrelated parties in the same

[144] Henshall, J & Reams, K, 2011, 4. See also Georgia-Pacific Corp. v. United States Plywood Corp.
[145] Henshall, J & Reams, K, 2011,1-2

or similar circumstances[146]. Between independent enterprises what matters is negotiation power. Regarding the rule of thumb the US Court condemned that it doesn't take into account the unique relationship and the negotiation power of the parties. When the arm's length principle is to be applied technology, industry and relative bargaining power of the parties play a significant role in the negotiations. Hence, the use of "artificial" rule of thumb in determining remunerations between related parties is incorrect under the arm's length principle. [147]

The current review of OECD's Working Party No. 6 on Chapter VI is intended to clarify the application of existing transfer pricing concepts to intangible property and not to introduce totally new guiding. As the cornerstone of the arm's length pricing is to benchmark related-party transactions against what would happen between independent parties, commercial courts' decisions like this case are informative in illustrating how one would approach the question of a hypothetical license agreed between a willing licensee and a willing licensor. [148]

# 7. Case law in Finland

## 7.1. Reasonable compensation

### 7.1.1. Compensation in copyright infringements

From all the intellectual property cases in Finland copyright disputes are definitely the most common ones. Case law in Finland includes various examples on how compensation in copyright infringements is being solved. Corresponding cases of patents and trademarks do not exist in a similar manner because disputes on patents and trademarks are less common than copyright disputes. This, however, does not mean that the same logic would not be applicable in corresponding patent and trademark cases. As presented in the valuation chapter of the paper under Patent Act, Copyright Act and Trademark Act, determination of compensation in infringement situation is fairly identical. Furthermore section 6 of Chapter 17 of Finnish Code of Judicial Procedure leaves the court opportunity to use its assessment in determining reasonable compensation in unclear situations.

[146] Miesel et al. 2002, 22
[147] Henshall, J & Reams, K, 2011, 1-2
[148] Henshall, J & Reams, K, 2011, 1-2

Supreme Court's decisions with their respective decision numbers KKO:1989:87, KKO:1989:151, KKO:1996:43, KKO:1995:202, KKO:1998:91, KKO:1999:115, KKO:2001:42, KKO:2005:43, KKO:2007:63, KKO:2010:47 and KKO:2011:92 all deal with copyright infringements. Also Court of Appeals' 15.11.2007 3699 deals with copyright infringement. Section 57 of the Copyright Act defines that anyone who infringes copyright is obligated to pay reasonable compensation to a holder of a right. These case law examples show how reasonable compensation has been reasoned in Supreme Court's decisions. KKO:2005:43, KKO:2011:92 and Court of Appeal's 15.11.2007 3699 are being presented more in detail further on and will not be discussed at this point.

According to section 57 of Copyright Act the purpose of reasonable compensation is to bring the holder of a right to same position that he/she would have been without infringement of the copyright. Simultaneously the idea is that the infringer won't get better position by infringing the right than he/she would have acquired by using the right with permission.

In legal praxis (KKO 1989:87, KKO 1995:202, KKO 1998:91 and KKO:2001:42) starting point for an assessment of reasonable compensation has established to be normal compensation for the use. Normal compensation for the use is interpreted as the compensation that the parties would have reached if they had negotiated the compensation in a normal market situation. Thus, compensation for the use is the licensee fee that would have been reached if no infringement had incurred. The court decisions listed above further show that reasonable compensation is, whenever available, based on the normal license payment of a product at the moment of the infringement. In order to reach total compensations this license payment is then multiplied by the amount of infringed products. In such case that normal license payment cannot be applied, the Supreme Court has based its calculations of reasonable compensation on the selling price that by paying that price the infringer would have bought the product protected by copyright to its business.

Supreme Court decisions KKO:1989:151, KKO:1999:115, KKO:1996:43, KKO:2007:63 and KKO:2010:47 at the same time demonstrate that not in all cases normal license fees or market prices can be used in the raw. These cases verify that special characters of each case are required to take into consideration in determining whether normal licensee payment can be used as such. Supreme Court in its decision KKO:1989:151 states; the more the exploitation of an infringed asset deviates from the normal use of the same asset to which normal compensation for the use is based on, the more normal compensation for the use is an

inappropriate base for reasonable compensation in infringement situation. Already the law uses the term “reasonable” in setting compensation which refers that the court needs to assess special character of each case in order to decide what is reasonable.

### 7.1.2. Implications on transfer pricing

Supreme Court’s decision to base determination of reasonable compensation on normal license payment charged in the particular industry indicates that the Supreme Court favors the market approach in setting a price for an intellectual property. From transfer pricing methods, in turn, this refers to the comparable uncontrolled transaction method. The fact that the Supreme Court uses the market approach in forming reasonable compensation refers that the court sees the market approach pricing as a reasonable compensation form that reflects the value of the infringement. As the purpose of reasonable compensation is to bring the holder of a right to same position that he/she would have been without infringement of the right applies that the objective in pricing between unrelated parties is consistent with the arm’s length pricing of transfer pricing.

Supreme Court has also noted that not in all cases normal compensation for the use should be used as such as the basis of reasonable compensation but special characters of the case should be taken into a consideration. The more the exploitation of an infringed asset deviates from the normal use of the same asset to which normal compensation for the use is based on, the more normal compensation for the use is an inappropriate base for reasonable compensation in infringement situation. This perception of the Supreme Court is also consistent with the comparability analysis of the transfer pricing guidelines. In transfer pricing if characteristics of the comparable transaction differ much from transaction under examination, the comparability must be proven and possible adjustments made. Therefore the statement of the Supreme Court’s to “fix” the market price is in line with the comparability analysis and in making possible adjustments as described in the transfer pricing guidelines.

Analysis of these copyright cases serves as a valuable proof that Finnish Supreme Court has committed itself several times what is a reasonable “value“ of intellectual property in the case of an infringement. These cases, therefore, clearly answer the question on how transaction involving intangible asset should be priced and to what extent comparability needs to be assessed.

#### 7.1.3. Interview comments on the matter

The outcomes of these Supreme Court decisions are endorsed by transfer pricing practice as well. Mr. Henshall calls these intangible assets, that the copyright cases covered, "me too" intangibles. "Me too" intangibles are non-unique intangible assets that can be bought from several sellers. The seller normally does not have much bargaining power and usually a marker price for the asset exists. "Me too" intangibles could and should be generally priced by using the CUP/CUT-method. However, even though "me too" intangibles are non-unique in nature the comparability of the transactions evaluated must be proven. Since "me too" intangibles have normally market prices and several sellers sell similar or alike assets, comparability generally can be proven.[149]

Mr. Henshall compares "me too" intangibles to unique intangibles. Unique intangibles, as the name says, are unique in nature. He uses as an example the story of Harry Potter. The story of Harry Potter is certainly a unique asset and in the case of transferring the rights of Harry Potter, no comparable uncontrolled transaction would be found. The idea is that the CUT-method should be applied to unique intangibles as well. However high level of comparability is required and often in practice, like in the case of Harry Potter, sufficient comparability cannot be reached. [150]

In such cases that the comparability cannot be reached, the second best method in transfer pricing would be the transactional profit split method. Especially Mr. Henshall mentions Jay-Lor v. Penta case from Canada as an illustrative example on how the profit split method has been applied in commercial courts outside Finland. [151]

### 7.2. Patent infringement: Supreme Court KKO:2003:127

#### 7.2.1. Preview

The case deals with patent infringement and appropriate remuneration for the exploitation of the patent. The city had standby equipment for oil spill contingency. The equipment was protected by patent but the city did not have permission of the patentee to exploit the equipment. Supreme Court decision stated that the city infringed the patent. The court also

[149] John Henshall, interview 2.2.2012
[150] John Henshall, interview 2.2.2012
[151] John Henshall, interview 2.2.2012

heard question of prohibition of use and liability of damages. Liability of damages is discussed below.

The patent no. 70443 was granted 19.9.1986 for company A. The patent dealt with equipment to collect oil from water level. The city bought a vessel for oil spill contingency from company B. The vessel included the equipment that was protected by the patent. The Supreme Court found that the city infringed the patent because it exploited the equipment that was protected by the patent no. 70443 and it didn't have license right for the patent. Company A claimed compensation from the city due to exploitation of the equipment that infringed the exclusive rights of the patentee. Company A didn't claim compensation due to the purchase of the equipment. The Supreme Court found that the city was liable to pay reasonable compensation for the use to company A. The court stated the compensation for the use to be a license payment that company A would have acquired had it sold the equipment for the city itself.

The Supreme Court based its assessment of appropriate license payment on similar transaction occurred between independent parties. A request for quotation between third parties revealed market price for identical equipment and that the payment for such equipment was a lump sum and that lump sum already included the license payment for the use of the patent. Based on the comparable transaction the Supreme Court decided the lump sum payment for the license had been applied also between the city and the company A. The Supreme Court found that the reasonable compensation for the use, that lower court had sentenced the city to pay to company A, was consistent with the lump sum payment charged between independent parties.

### 7.2.2. Implications on transfer pricing

The decision of the court to base the license payment on price charged between third parties is a perfect example how civil law court cases use similar reasoning to set a price for an asset than transfer price uses by following the arm's length principle. The Supreme Court based its decision on request for quotation that established the market value of such license and also how independent parties would have constructed the price. The Supreme Court applied the market approach by comparing the transaction under dispute to a similar transaction between third parties. The court based its decision on so called "external comparable" which in the OECD guidelines refers to a comparable transaction between two independent enterprises, neither of which is a party to the transaction in question.

Besides observing comparable transactions, the court performed its comparability analysis as well. The court allowed the use of the request for quotation as a reference because the request for quotation involved identical asset, it was offered in the same time period, under similar economic conditions and contractual terms. Thus the request for quotation objectively presented a market price for the equipment for oil spill contingency. The court's assessment on the comparable factors of the two transactions is consistent with Chapter III and section D of Chapter I of the OECD guidelines that discusses in detail comparability analysis and important factors of the analysis. Paragraph 1.33 in the Chapter I states "to be comparable means that none of the difference (if any) between the situations being compared could materially affect the condition being examined in the methodology (e.g. price or margin), or that reasonably accurate adjustments can be made to eliminate the effect of any such differences" and it can be concluded that the court's comparability assessment fits within this guidance.

The royalty payment paid in the comparable transaction was a lump sum that was paid once, simultaneously with the purchase price. This kind of lump sum payment already including the royalty fee is also consistent with paragraph 6.17 of the OECD guidelines. Transfer pricing practice has demonstrated that a payment for an intangible asset may be a lump sum payment, running royalty payment or a mix of these two. It is important to consider specific characteristics of the asset and the transaction in determining which of the payment forms is the most appropriate in a particular case. Benchmarking to independent transaction is a recommendable activity under the OECD guidelines and under the current transfer pricing practice and by benchmarking to a comparable transaction and by applying the lump sum payment to this particular case also, the court acted completely in line with the transfer pricing guidelines.

All in all, the decision of the court is a clear statement in favor of the market approach and the comparable uncontrolled transaction method. The court's decision is completely consistent with the paragraph 2.3 of the guidelines stating that whenever possible the comparable uncontrolled price method is preferred method to all other methods. The court didn't even question whether comparable transaction should be used as a base in determining right compensation for use. The court automatically assumed that similar third party transaction describes in a best manner a reasonable compensation. The court didn't look for costs

incurred when developing the patent (cost approach) neither had it analyzed its expected future income streams (income approach). It clearly held on the market approach.

However, in order to apply the comparable transaction method the comparability between the transactions needs to be proven. This requires comprehensive analysis of the transaction and the parties involved. In this case it is exactly what the court did by reviewing the "comparable" factors of the comparable transaction that are also presented in the comparability analysis section of the transfer pricing guidelines. All in all the decision of the court and the reasoning behind the decision is a clear indication that civil law case examples may be used to interpret transfer pricing decisions as well. This case strongly argues on behalf of the market approach and the comparable uncontrolled transaction method in disputes regarding reasonable compensation for the use. It is to be noted that even though civil courts do not lean on transfer pricing guidelines, and they don't use the terms "arm's length price" or "comparability analysis" as such, they apply these concepts in their decisions by using other words.

#### 7.2.3. Interview comments on the matter

Mr. Henri Kaikkonen, a lawyer specialized in intellectual property cases also favors the market approach –based thinking in determining reasonable compensation or damages for infringement. Mr. Kaikkonen comments that since often in legal praxis direct market prices of intellectual property cannot be found, hypothetical negotiation is the starting point to determine compensation. Hypothetical negotiation, on the other hand, reflects the market approach as it considers what the parties would have negotiated had the infringement not occurred.

Mr. Kaikkonen, however, notes that in Finland patent infringement cases where the court puts significant emphasis on the determination of reasonable compensation are infrequent. However, Mr. Kaikkonen sees the market approach as the most appropriate and logical approach to determine compensation in the case of infringement. He wouldn't rule out the possibility that the court would apply the income approach in determination of reasonable compensation but the cost approach, on the other hand, he sees that as a very unlikely alternative. So far Finnish case law hasn't shown any evidence in favor of the cost approach. [152] The market approach and the hypothetical negotiation are also valued high when discussing with Mr. Karjalainen and Mr. Henshall about appropriate ways to set a transfer price for an intangible asset.

[152] Henri Kaikkonen, interview 21.3.2012

### 7.3. Copyright infringement: Supreme Court KKO:2005:43

#### 7.3.1. Preview

A Swedish language textbook comprised two parts; a text section and a vocabulary. A company had copied the vocabulary to diskettes and started marketing the diskettes. The textbook was protected by a copyright and the company didn't have the copyright owners' permission to exploit the vocabularies in their diskettes. The Supreme Court found that the company infringed the copyright of the textbook. The question that the Supreme Court held was the reasonable compensation for the use and whether the defendants were obligated to compensate the damages caused to the plaintiffs.

Generally in intellectual property case law reasonable compensation is based on normal license fees or on royalty payments. In this case the Supreme Court found that the reasonable compensation is the amount the copyright owners would have charged from the copyrights if they had negotiated the licensee fee under normal market circumstances without the infringement. Since the vocabularies, used in the diskettes, could be acquired by buying the textbook, the court determined the reasonable compensation for each diskette to be the market price of the textbook. The market price was then multiplied by the amount of diskettes sold in order to get the total compensation.

Reviewing the question of damages, the court committed oneself whether the infringement had caused financial damages to the plaintiffs. The plaintiffs argued that the infringement had caused market disturbance, disturbance in customer relationships and reduced goodwill value of the company. Since the plaintiffs were not able to demonstrate any specification of damages incurred, the court dismissed the complaint about compensation for damages.

#### 7.3.2. Implications on transfer pricing

This court case is a good example on how reasonable compensation in copyright cases is determined and on how soft intangibles are analyzed in the courtroom. Previous legal praxis and as well as this case point out that whenever possible in determining reasonable compensation the court uses the market price of an infringed product and multiplies it by the amount of an infringed product. If market prices are not directly available or usable for a certain comparison, they can be used as a benchmark price, which is then adjusted according to each case.

This particular case and all the other similar cases where a reasonable compensation is based on market prices clearly favor the CUP/CUT method in transfer pricing. Court's primary objective is to search for transactions involving similar assets and then use these market prices to calculate a reasonable compensation. Court's decision-making goes hand in hand with the paragraph 2.3 of the OECD guidelines stating that whenever possible, the comparable uncontrolled price method is the most preferred method over the other methods. Court clearly uses the same analogy that is used in transfer pricing, in determining a reasonable compensation in a case of an infringement of an intellectual property.

Paragraph 2 of Section 57 of Copyright Act states that if the work is used willfully or out of negligence, the infringer shall, in addition to compensation, pay damages for any other loss, including mental suffering and other detriment. Compensation for damages is, however, always to be considered separately. In Supreme Court decision KKO:1995:205 it has been concluded that generally in the case of copyright infringement the amount lost in operating income is the compensation for damages. Infringement can also cause impairment of business value or disturbance in customer relationships.

In determining damages for the copyright owners the Supreme Court performed a comprehensive analysis of the bargaining power of each party. The court recognized that to some extend the infringement had caused market and customer relationship disturbance to the plaintiffs but the damages needed to be analyzed in its context in order to decide compensation for damages. Therefore by taking into consideration the small amount of diskettes sold, the plaintiffs' dominant market position in Swedish textbook markets; the Supreme Court found that no compensable damages had incurred. The court's comprehensive assessment of the situation is a clear indication that also in transfer pricing each case is to be analyzed in its context by taking into account bargaining power of each party. The focus should be in the basics; what is the basic nature of the asset in question, what are the market positions of the parties involved are and who has the bargaining power in the negotiations. As the court showed the emphasis is really on observing the basic elements of the transaction and seeing what is really going on in order to make an appropriate, justified decision.

Another important implication of the court' decision is that actual evidence is needed in order to condemn compensation for damages. Claimed damages on goodwill or customer relationships were not enough to sentence compensation for damages. This requirement for evidence has implications on transfer pricing as well, when it comes to transactions involving

soft intangibles. Current transfer pricing discussion on whether soft intangibles (like strong customer relationships or workforce in place) should be priced when determining an appropriate transfer price, should see how case law resolves this question. Currently tax authorities try to price soft intangibles in order to receive higher local tax profits but taxpayers on the other side of the transfer pricing table argue against[153]. Now the argument against calculating and pricing soft intangibles into the transfer price gets support from intellectual property case law. When actual value damages/effects on customer relationship under intellectual property case law or actual superior customer relationship in transfer pricing cannot be proven, they should be left out from the transfer price calculations. In order the court to condemn damages based on disturbance in customer relationships, they require proof. By following the arm's length principle same verifiability should be applied in transfer pricing audits as well. In order to set higher transfer price due to strong customer relationship, proof is required. If in transfer pricing it cannot be shown that a specific company has extraordinary customer relationships that comparable companies do not have, increment in transfer price based on soft intangibles cannot be applied. Extraordinary value importance requires evidence.

If the requirement for evidence supporting damage claims in case law seems obvious, why wouldn't it be obvious in transfer pricing? For most of the readers of court decisions it makes perfect sense that in order to receive compensation for damages, it is required that the damages incurred are somehow proven. If transfer pricing practice under the arm's length principle should act as the real world does, shouldn't the verifiability be required in transfer pricing audits as well? Tax authorities cannot argue on behalf of higher transfer price based on soft intangibles like strong customer relationships if they cannot prove the exceptional nature of these customer relationships.

This case demonstrates, what several copyright cases have shown in Finland that generally reasonable compensation for infringement is a market price of an infringed product multiplied by a number of infringed products. Compensation for damages, in turn, is to be evaluated separately and the emphasis should be on the relevant factors of each case. Value of the damages requires also to be proven and this applies to damages in soft intangibles as well. The fact that the court required evidence supporting damages on customer relationships or

[153] Henshall, J & Smith, G[2], 2012, 1

goodwill, implies that either transfer pricing should price soft intangibles without clear evidence of their exceptional value.

#### 7.3.3. Interview comments on the matter

Analysis of the soft intangibles' valuation also gets support from the interviews. When discussing compensation for damages in the case of intellectual property infringement, Mr. Henri Kaikkonen comments that the court highly unlikely grants compensation for damages if the damages cannot be proven. In several cases case law recognizes the possible damages in customer relationship or in goodwill but actual compensation for damages may not be granted if realization of damages cannot be proven. Mr. Kaikkonen notes that verifiability is considered to be the starting point for granting compensation for damages. [154]

### 7.4. Copyright infringement: Court of Appeal 3699

#### 7.4.1. Preview

The plaintiff of the case is Yle, which is Finland's national public service broadcasting company and the defendant is Gramex. Gramex is a copyright society that promotes and administers the rights of performing artists whose performances have been recorded on phonograms and of producers of phonograms. The case deals with appropriate remuneration that Yle should pay to Gramex for the use of its copyrights. The relevant question is; what the reasonable compensation of the copyrights should be and how should it be constructed? The Court of Appeal of Helsinki hold the case and further leave to appeal to Supreme Court was not granted.

In determining the appropriate remuneration, in accordance with the Copyright Act, the court committed itself whether the payment should equal to payment that commercial radio pays for the same rights to Gramex. The court took the view that Yle's business idea is not similar to commercial radios' business idea. Commercial radios receive their income from commercials and their income revenues depend on how many listeners the radio has. Yle, on the other hand, does not depend on income deriving from commercials and its revenue is not dependent on the amount of listeners. Therefore the court decided that the payments that Yle makes to Gramex don't need to equal to payments that commercial radios make to Gramex for the use of same rights. The court, however, stated that the compensation needed to be reasonable and in the assessment of reasonable compensation, the payments made by commercial radios to

[154] Henri Kaikkonen, interview 21.3.2012

Gramex were important to take into account. The Court of Appeal found that the compensation paid by Yle to Gramex must not be significantly higher than compensations paid by commercial radios for the same rights.

### 7.4.2. Implications on transfer pricing

The key issue, in determining whether the payments paid by Yle to Gramex should be equal to payments paid by commercial radios, is to analyze the business idea; functions performed and risk undertaken by commercial radios and Yle. In transfer pricing terms it deals with the comparability analysis. The comparability factors to be considered in each case are the characteristics of the property, the functions performed by the parties, contractual terms, the economic circumstances and the business strategies [155]. In different cases different comparability factors have a key role. In this case functional analysis and business strategies are the crucial questions when determining comparability of the compensation for use that the parties pay to Gramex. Characteristics of the property, copyrights for records, were identical in this case because same records were used in commercial radios and in the channels of Yle. Also contractual terms and economic circumstances for commercial radios and Yle don't make much difference because both operate in the same market and compete for the same listeners. Furthermore Gramex is the only representative offering such records and thus each party needs to buy the rights from Gramex.

Functional analysis seeks to identify and compare the economically significant activities and responsibilities undertaken and risks related to these activities[156]. Differences between commercial radios and Yle arise from the functions performed and risks involved of both providers. As mentioned, commercial radios receive their income from commercials and the amount charged from each commercial depends on the amount of listeners at the hour when the commercial is played. Commercials are the principal income of these radios. Yle, on the other hand, does not play commercials and its income is not directly dependent on the amount of its listeners. Yle also has a more versatile program than commercial radios and, thus, playing protected records does not have such a big role than in commercial radios. Therefore it can be concluded, like the court did, that significant differences in activities and responsibilities undertaken by the parties exists.

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[155] Paragraph 1.36
[156] Paragraph 1.42

Furthermore risk assumed by the parties is different. Commercial radios compete on constant basis with other radios and they can be driven to bankruptcy if they don't succeed. Yle, even though it competes with commercial radios for listeners, has more protected position in the market. As it is a national public service broadcasting company it cannot be driven to bankruptcy in a same manner than commercial radios. Hence, commercial radios bear much more risk than Yle performing the same activities (playing records protected by copyrights). In commercial radios copyrights have bigger role in income formation and therefore copyrights' value in use in commercial radios is higher. Increased value importance reflects, again, to higher risk. Usually in the open market, when the risk increases the expected return increases or otherwise there would be no incentive to enter into such business. In this case the increased expected return is acquired by lower input prices. Commercial radios, as we know, have so far had the incentive to enter into the market and the incentive has been the possibility to challenge Yle. Hypothetically speaking, if it were only about playing the music, commercial radios wouldn't even exist if they would have the same input prices than Yle has. They wouldn't survive in the competition if they wouldn't receive higher return for their higher risk. Of course in real life, commercial radios' existence does not only depend on the compensation for the use of copyrights, but it can definitely be concluded that the court made a logical decision after performing its "functional analysis" discussed also in transfer pricing.

Even though the Court of Appeal didn't impose the reasonable compensation paid by Yle to Gramex to be equal to those paid by commercial radios, the statement indicates that whenever possible, the arm's length price should be applied. The statement of the court indicates that the arm's length price should be used as a benchmark and appropriate adjustments for this benchmark should be made according to each particular situation. In this case the court decided that sufficient comparability between functions of Yle and functions of commercial radio was lacking and thus the compensation paid by commercial radio could not be applied directly to Yle. The court based its decision on comparability analysis of the two parties. The case is a strong argument for the market approach and the CUT-method. It shows that the objective is to apply market based pricing and when it is not possible to apply directly, it should be used as a benchmark and then perform required adjustments according to each case.

### 7.4.3. Interview comments on the matter

Interviews with Mr. John Henshall and Mr. Jukka Karjalainen give similar kind of outcomes. The two transfer pricing experts argue that the market approach and the CUT method are the

first options to apply whenever possible. As the market approach observes third party transactions and follows the arm's length principle it is the most appropriate approach to be used. However, both Mr. Henshall and Mr. Karjalainen highlight that the comparability of the comparable transactions must be ensured. If the comparability cannot be ensured the market approach or the CUT method cannot be applied. In such cases the income approach should be used.[157]

Even though the two transfer pricing experts are on the same wavelength in requiring comparability in order to use the market approach and the CUT method, slight differences in the required level of the comparability exists. Mr. Henshall seems to demand more precise level of comparability whereas Mr. Karjalainen is a bit less strict in demanding full comparability. Mr. Karjalainen clarifies the difference by commenting that under Finnish intellectual property case law, even though exact comparability cannot be proven, comparable transaction may serve at least as a benchmark for the assessment, which is then adjusted.

Mr. Karjalainen notes that this requirement level difference possibly stems from the differences in legal praxis between countries. In the Anglo-Saxon countries, like the UK, case law has an increased importance in forming legal praxis. In Finland, on the other hand, case law decisions are more easily revised and it may cause that the court don't need to be so harsh in making decisions than in the Anglo-Saxon countries, where the court decisions are less frequently revised (although the Uniloc case demonstrated that also in the Anglo-Saxon countries previous court decisions may be revised).

## 7.5. Copyright infringement: Supreme Court KKO:2011:92

### 7.5.1. Preview

The case deals with transfer of copyrights. Translator to Finnish H had made a translation agreement with publishing company WSOY. H had given exclusive right to WSOY to copy and publish the translation of the literary book in a form of a book and under its own name. All the other rights of the translation stayed with translator H. WSOY published the book as agreed. After the publication WSOY made agreement with Loisto, other publishing company and gave it right to produce and publish the same translation in a form of a pocket book. The Supreme Court sentenced that WSOY and Loisto infringed the copyright of the translator H

[157] John Henshall,interview 2.2.2012, Jukka Karjalainen, interview 16.3.2012

when WSOY forwarded the copyright to Loisto. The Supreme Court concluded that the publishing companies were obligated to compensate the infringement. The interesting question was how the compensation was decided?

The Supreme Court decided that the reasonable compensation should be the payment the holder of a right would have received when negotiated in a lawful situation. Thus the translator H was entitled to receive the compensation it was missing. The court found that comparable license payment didn't exist. In the determination of the right compensation the court gave strong emphasis on negotiation power of the parties and highlighted the remuneration to be reasonable. The statement was that the compensation should be the amount that the translator H would have negotiated for himself/herself in a situation of further publishing under lawful circumstances (without infringement). The publishing companies argued that since H gave exclusive right to WSOY, H couldn't have negotiated on its behalf with any other publishing company concerning further prints. WSOY and Loisto also argued that the remuneration was a lump sum and thus it didn't even depend on the number of the actual prints. The court, however, noted that if H would have known in the inception of the negotiation that pocket book edition achieves notable extra sales, it would have had more negotiation power in order to negotiate higher compensation from the translation work.

The court made its decision about the appropriate compensation based on the royalty payments that WSOY paid to Daniel Steel, the author of the original book, and on the original payment made by WSOY to translator H for the original translator. The Supreme Court decreased the compensation from one fourth to one eight of the original compensation. The Court of Appeal had decided the compensation to be 25% of the original remuneration paid to H but after considering the royalty payments made to Daniel Steel, the Supreme Court lowered the compensation approximately to one eight.

#### 7.5.2. Implications on transfer pricing

The case argues both in favour of the market approach and the profit split method. The market approach, comparable uncontrolled transaction was the way the court sought to determine the reasonable compensation. When information on comparable license agreement was not available the court estimated the reasonable compensation based on negotiation power of the parties and then benchmarked it to the royalty payments paid to the original author. Even though the compensation was not based on the profit generation of the book the consideration of the bargaining power and then the splitting of the original remuneration is indication on

behalf of the profit split. Paragraph 2.108 regarding the profit split method includes "*determining the division of profits that independent enterprises would have expected to realise from engaging in the transaction or transactions*". The court used this kind of assessment when deciding the appropriate split of the original compensation. Thus the court's assessment was similar with the paragraphs 2.108 of the transfer pricing guidelines on how to exercise the profit split method. First determining the amount to be split and then selecting appropriate splitting between the parties. In determining an appropriate profit split or a royalty payment, negotiation power of each party was in a key role. The court recognized this also by taking into a consideration that the translator H would had had better position to negotiate remuneration for the translation if she/he would have known that pocket book edition increases the sales significantly. This statement, on the other hand, supports the following assumption (analyzed more in detail in the next paragraph); publishing companies' remuneration system for freelancers is based on expected profit generation of a particular book.

A relevant argument in favour of the profit split method is that the court first based its assessment of a reasonable compensation on the original remuneration paid by WSOY to translator H at the inception of the translation work. It is reasonable to assume that lump sum freelancer compensations paid by publishing companies to freelancers are to some extent based on expected future sales of a particular book. Without going any deeper to publishing companies' remuneration system, it is totally reasonable to assume that a publishing company pays much more money for translation that is expected to be sold one million pieces than the ones with expected sales of few thousands. Therefore, as the original remuneration is formed by its expected profit generation and the court based its assessment of reasonable compensation on the original compensation, which was then split to both parties, it can be concluded, that the court decision reflects the profit split method. As the starting point, the original compensation of a translation is calculated based on its expected profit generation, splitting the compensation in different ways does not change the fact that the compensation is then based on its profit potential. Therefore a reasonable compensation that is derived from the original compensation is also profit generation based compensation and, thus, consistent with the profit split method.

Besides splitting the original remuneration the court used also benchmarking in its decision. It compared its calculations of splitting the original compensation to the royalty rate paid to

the original author of the book. The court's decision is, therefore, a combination of the market approach and the income approach. Benchmarking represents the market approach and the CUT method meanwhile splitting the original remuneration presents the income approach and the profit split method.

The case does not comment directly the ownership question regarding legal and economic ownership. However, the court decision does reflect the importance of the bargaining power in the negotiation of economic ownership. As WSOY infringed the legal rights of the translator H, it simultaneously violated translator H's economic rights. If translator H would have known that WSOY was planning to make a pocket book edition which increments significantly the sales, translator H would have had better bargaining power in the compensation negotiations and he/she could have negotiated higher royalties for the translation.

#### 7.5.3. Interview comments on the matter

As discussed in context with the previous cases, all interviewees argue that whenever possible the market approach is the most appropriate approach to valuate intangible assets. The second best approach, according to Mr. Henshall and Mr. Karjalainen is the income approach and the transactional profit split method that also this case partly presents. The cost approach receives lesser credits.

This case slightly comments the ownership question but not very deeply. All in all in the search for Supreme Court precedents that discuss legal v. economic ownership, I noticed that there weren't any clear cases. Surprised by the result I discussed with Mr. Kaikkonen on the question. His comments were that since intellectual property cases in Finland with extensive damages-related reasoning are quite infrequent and disputes that could cause this kind of reasoning in the courts are often solved outside the courtrooms, no such cases can be found in the case law.

### 7.6. Liability of Damages Supreme Court KKO:2005:105/Court of Appeal 2552

#### 7.6.1. Preview

Fiskars PLC (Fiskars), a holder of a copyright of design had sent a letter to retailers of its competitor Rediviva Ltd (Rediviva). The letter argued that Rediviva's product infringed the copyright of design and all actions infringing the copyright of design must be stopped.

Rediviva’s retailers stopped buying company’s product. Later on the Supreme Court found that Rediviva’s product did not infringe the copyright of design and that there was a cogent reason that the procedure of Fiskars had caused damages to Rediviva. Due to the order of Court instance the Supreme Court returned the case regarding compensation for damages to be solved in lower courts.

Trademark of Rediviva’s product that was claimed to infringe Fiskars’ copyright of design was called Finman. Trademark Finman included other products as well. Rediviva demanded compensation for damages for three reasons; lost license payments for lost sales of claimed product, decrease in sales of other products under the trademark Finman and impairment of trademark value. The court found Fiskars to pay damages for lost license payments. Compensation for damages due to decrease in sales of other products and impairment of trademark value were not granted.

In determining lost license payment the court based its assessment of appropriate royalty rate on contract that Rediviva had made with its retailer before the retailer stopped purchasing Rediviva’s product. The court then multiplied the royalty payment by number of lost sales measured in product units. The amount of lost sales in units was assessed based on expected sales of Rediviva’s products. Rediviva’s expected sales, on the other hand, were estimated by purchase receipts verifying orders of Rediviva’s product and by hearing expert opinions on expected total sales of similar products in the market.

Rediviva claimed that the accusations of Fiskars had decreased sales of other Finman trademark products as well and had led to the impairment of the trademark value. The court however dismissed the damage claims on these matters. The court found that Rediviva was not able to prove the impairment of its trademark. Rediviva was not able to prove marketing investments made for the trademark nor results of these investments.

#### 7.6.2. Implications on transfer pricing

The court’s decision to base compensation for lost license payments is consistent with the market approach. Royalty rate used in the court’s decision was based on a contract that would have been applied with a retailer if the infringement accusations hadn’t incurred. The court endorsed its decisions to use royalty rates agreed in the particular contract by revising royalty rates that other retailers had paid to Rediviva. This implicates that in transfer pricing terms the court used an “internal” comparable to verify the appropriate royalty rate.

Compensation for impairment of the value of the trademark and for decreased sales was dismissed by the court due to the lack of evidence. The requirement of proofs was an essential step in order to grant damages for value changes in the so called soft intangibles. This case especially highlights the importance of evidence because it should be remembered that the Supreme Court itself returned the case regarding damages to lower courts. Therefore it is reasonable to state that the Supreme Court expected that damages had incurred and after deciding that infringement of copyright of design was not incurred, it stated that "there is a cogent reason for liability of damages". Finally, however, compensation was only granted for lost license payments but not on the basis of soft intangibles. The court decision is, therefore, a strong indication that in order to valuate or devaluate soft intangibles into the price, their value effect needs to be proven. Mere estimations that soft intangibles add value to a particular asset are not enough in transactions between unrelated parties. In transfer pricing this means that extra care should be taken when controlled parties determine to what extent firm and asset specific values of soft intangibles are included in the transfer price. If value effect of a particular item of an intangible asset cannot be proven, by following the arm's length principle, it should be left out from the price setting when determining the appropriate transfer price. Based on unrelated party transactions there are no grounds on why soft intangibles with not-proven value potential should be included in the transfer price.

#### 7.6.3. Interview comments on the matter

The court decision for not valuing (or devaluing) soft intangibles into the price is consistent with John Henshall[158] arguments that "it will rarely be the case that soft intangibles add significant bargaining power to either entity in a transaction in isolation. Most cases any soft intangibles that do add value will also be present in the comparable companies identified in the transfer pricing analysis such that the arm's length price is unaffected. For any soft intangibles identified and contended to have significant value for one entity reference must be made to the impact seen in transactions between third parties. Failure to observe this in third-party transactions means that the fundamental basis of the arm's length principle is not met." [159]

[159] John Henshall, interview 2.2.2012 and Henshall, J and Smith, G[2], 2012, 3

Even though the court's decision was not about transfer pricing and comparable transaction, the analogy is the same. In order to value soft intangibles in price setting their particular value potential requires proof. If proof cannot be found, it can be an indication that the soft intangible in question is rather common or even a lifeline among the companies in the same industry. Also Mr. Kaikkonen's interview supports these findings. As already discussed in copyright infringement case KKO:2005:43, realization of damages in soft intangibles, which are often debated regarding damage claims, needs to be proven. If they cannot be proven, they cannot be valued or devalued in the compensation[160].

## 8. Summary of the case law findings

This chapter summarizes findings of the case law examination. Table 1 includes the results of the use of the valuation approaches. Table 2, in turn, summarizes the factors affecting the valuation.

**TABLE 2. FREQUENCY OF THE DIFFERENT VALUATION APPROACHES**

| VALUATION APPROACH | Market Approach | Income Approach | Cost Approach |
|---|---|---|---|
| Direct use of the approach without adjustments | 7 | 0 | 0 |
| Use of the approach with adjustments | 6 | 0 | 0 |
| Use of the approach as a combination with another approach | 1 | 1 | 0 |
| **In total** | 14 | 1 | 0 |

From the 14 cases examined in this study, seven cases gave evidence of the direct use of the market approach without any adjustments made to the market prices. In these cases the court condemned the reasonable compensation to be the market price of the infringed product at the time of the infringement multiplied by the number of infringed products.

In six cases the court used the market prices as a starting point to determine a reasonable compensation but didn't use the market price as such. In these cases the court used the market

[160] Henri Kaikkonen, interview 21.3.2012

prices as a benchmark price that was then adjusted with relevant factors of each case. Furthermore in one case the court applied a combination of the market approach and the income approach to set the reasonable compensation. The court didn't apply the cost approach pricing in any case.

**TABLE 3. FREQUENCY OF THE FACTORS AFFECTING THE VALUATION**

| **Definition** | | **Ownership** | |
|---|---|---|---|
| Compensation is granted based on the legal definition. No broader influence of the infringement on other intangible elements was discussed | 12 | Benefits arising from the asset directed to its legal owner | 13 |
| Broader definition of intangible asset is recognized, but higher compensation is not granted due the lack of verifiability | 2 | Court gave evidence that relevant economic factors taken by each party may change economic conditions agreed earlier based on legal ownership | 1 |
| Broader definition of intangible asset is recognized and compensation is based on the broader definition | 0 | Benefits arising from the asset directed partly to some other party than the legal owner | 0 |
| **In total** | 14 | | 14 |

Table 2 demonstrates frequency of the factors that are relevant in the valuation of intangible asset. The column of definition shows that in 12 cases the compensation was granted merely based on the infringement of the registered intellectual property. In these cases the court didn't analyze possible damages in soft intangibles. In two cases, the court recognized the broad definition of intangible asset and assessed its effect on the compensation. Sufficient evidence of the value of the soft intangibles, however, was not proven and, therefore, compensation based on soft intangibles was not granted. In any case the court didn't grant compensation based on intangible asset that are not intellectual property.

The ownership column, on the other hand, shows how the court determined to whom the compensation of the infringement should be allocated and possibly split. In all cases except in one, the court automatically directed the compensation to the legal owner of the asset. In one case the court analyzed the effect of the bargaining power in the negotiation of how the profits deriving from the property are allocated. In any case benefits arising from the asset were allocated to some other party than the legal owner.

# 9. Conclusions

## 9.1. Intellectual property case law provides answers to transfer pricing questions

This paper studied whether intellectual property case law in Finland has answered the question of how transactions involving intangible assets should be valuated. The paper also examined whether the definition of an intangible asset and the determination of who is entitled to the benefits arising from an intangible asset affect the valuation of the intangible asset. The foremost principle of transfer pricing is the arm's length principle that implies that transactions between associated parties should be solved as if they had incurred between unrelated parties. Therefore, answers to disputable questions in transfer pricing should be solved primary by reviewing how unrelated parties have solved the similar situation. Disputes regarding intangible assets between unrelated parties are being solved in intellectual property case law and, thus, this research concentrated on finding answer to a transfer pricing question by examining the intellectual property case law in Finland.

The empirical analysis on intellectual property case law in Finland provided evidence that intellectual property case law can be useful in solving transfer pricing disputes on transactions involving intangible assets. The study on case law discovered that the court dealing with disputes regarding intangible assets between unrelated parties has confronted the same questions that the transfer pricing arena is currently dealing with and the reasoning adopted by the court to reach its decisions is often very consistent with the fundamentals of the transfer pricing guidelines.

Court's reasoning that was found to be similar to transfer pricing objectives included the objective to use arm's length pricing in setting a compensation for the infringement. Appropriateness of the arm's length pricing was, however, carefully assessed by considering the same factors that are discussed in the comparability analysis of the transfer pricing guidelines. In such cases that the comparability was not properly met, the court sought to adjust the market price or turned to the income approach. Intellectual property case law was also proven to have battled with the value changes of assets like successful customer relationships, which in turn in transfer pricing practice are called soft intangibles. The case examples thereby demonstrated that intellectual property case law, when determining compensation in the case of infringement, has committed itself what can be included in the intangible assets' valuation and what is an appropriate approach to valuate intangible assets. Question of ownership and its effect on splitting the profits reached in the valuation, however,

was discussed in the Finnish case law to a very limited degree. Detailed conclusions of how definition and ownership assessment influence the valuation of intangibles and valuation as such are discussed below.

### 9.2. Valuation of soft intangibles requires proofs

Intellectual property case law examination provided evidence for transfer pricing, that in order to broaden the definition of an intangible asset over its legal definition, evidence is required. Soft intangibles, even though recognized their existence, cannot be priced if their value importance cannot be objectively proven.

Intellectual property law defines in exact terms what is a patent, copyright or trademark. Legal definitions of these properties have not been any issue in transfer pricing either. The intriguing question in transfer pricing has been, how far the definition can be broadened. Previous transfer pricing study seems to be unanimous that the definition of intangible asset goes beyond its legal definition. However, intangibles are always defined for some purpose, generally because they need to be valuated for transfer. In the valuation of these intangible assets, which are not legally defined intellectual property, arises the problem of how to valuate these unique firm-specific assets. If there exists valuation practice that verifies existence of the exceptional value of the asset[161], the valuation of these assets into the transfer price will not cause any conflict. The answer, however, based on this research changes when we come up with soft intangibles whose exceptional value potential cannot be verified objectively.

Soft intangibles, like discussed several times in this paper, are for example successful customer relationships or workforce in place. These assets in most cases are assets that every company has. They are assets that are needed in everyday business environment. They are often not exceptional or unique in nature. Companies within the same industry frequently have the same soft intangibles than the company in question. A good example is successful customer relationships. Yes, it can be seen as an asset of the company but it is often also a minimum requirement of the existence of the company. Competitors of the company have also successful customer relationships, because if they didn’t have they wouldn’t exist. This implies that in transfer pricing, these soft intangibles are already taken into consideration in a form of comparable transactions because, behind the transfer price of these comparables, are

[161] Valuation practice, in this context, can be for example balance sheet value of an asset or a bid offer; important is that the existence of the exceptional value potential can be verified objectively.

the same soft intangibles. Thus, the soft intangibles are already included in the arm's length price. As the taxpayers' side has recently argued, the arm's length principle implies that for any soft intangible identified and contended to have significant value for one entity proof is required and reference must be made to the impact seen in transactions between third parties. Failure to observe this reference means that the fundamental basis of the arm's length principle is not met[162].

This study provided evidence that in transactions between third parties in intellectual property case law, soft intangibles are not valuated in the compensation if their exceptional value importance has not been proven. Cases KKO:2005:43 and KKO:2005:105/Court of Appeal's 2552 gave clear evidence that between third parties soft intangibles cannot be valued or devalued into the price if their exceptional value potential is not proven. The outcome of these two cases also got support from the interviews as Mr. Kaikkonen commented that the verifiability is the starting point to assess damages in non-legally protected asset groups.

Therefore, based on the findings of this study the conclusion is that by following the arm's length principle of transfer pricing and by making reference to third-party transactions, soft intangibles in related party transactions should not be included in the transfer price when their exceptional value importance cannot be verified. Tax administrations, thereby, lack justification to argue for higher transfer prices for intangible assets due to the existence of soft intangibles in such situations where soft intangibles' value cannot be objectively observed.

### 9.3. The question of economic ownership remains unsolved

So far intellectual property case law in Finland has not confronted an unclear question where the court would have taken a view; who is the economic owner of the benefits arising from the intangible asset. Only the case KKO:2011:92 discussed the role of bargaining power in the negotiations of an appropriate profit split between a copyright holder and a licensee. However, the focus of the case was in the role of bargaining power in setting remuneration based on legal rights and not on questioning the possible separation between the legal ownership and economic ownership. Thus, it can be concluded that intellectual property case law in Finland does not offer any example on how the separation of the legal and economic

[162]Henshall, J & Smith, G, 2012[2], present this linkage in their working paper. See also paragraph 1.32 of the OECD guidelines, which reaffirms support for the arm's length principle and rejects the theoretical approach represented by formulary apportionment

ownership of an intangible asset has been done between unrelated parties and how it might affect price setting for intangible assets between associated parties.

The reason for the lack of questions battling between the legal ownership and economic ownership of an intangible asset might be the scarcity of intellectual property cases in Finland. As Mr. Kaikkonen commented, intellectual property cases in Finland with extensive damages-related reasoning are infrequent and settlements for disputes are often solved outside the courtrooms. Therefore, as no intellectual property case has taken sides on the matter, the conclusion is that intellectual property case law in Finland regarding the influence of the ownership on the allocation of profits is not useful for the purpose of solving transfer pricing disputes on the same matter.

### 9.4. Market approach is the primary approach to valuate intangibles

The study of intellectual property case law in Finland provided support for the market approach and the CUP/CUT method as the most appropriate valuation approach for intangible assets. The institutional background and similar previous studies, however, indicated in the beginning that the requirement to apply the market approach is a very high level of comparability. In such cases that sufficient comparability could not be proven, the income approach and the transactional profit split method was expected to be the second best approach to valuate intangibles. The findings of the case law examination largely provided support for these expected outcomes but the observed lower required level of comparability is a surprising outcome in the light of previous discussion on the matter.

All the case law decisions of this study provided evidence for the valuation of intangible assets. The case law analysis clearly indicated that in transactions between unrelated parties the market approach is the first best approach to valuate intangible assets. All 14 cases favored the market approach. In each case the court based its assessment regarding compensation for infringement on the market prices of the infringed asset. In such cases (KKO:1989:151, KKO:1999:115, KKO:1996:43, KKO:2003:127, KKO:2007:63, KKO:2010:47, KKO:2011:92, Court of Appeal's 3699, KKO:2005:105/Court of Appeal's 2552) that the court considered that the market price as such was not appropriate compensation the court adjusted the market price with the relevant factors of each case. However, in each case the starting point for the determination of the compensation was market prices of the asset under dispute.

Despite that the market approach ruled in the court decisions, also the income approach got reference. KKO:2011:92 decision was a mix of the market approach and the income approach. As the market prices were not directly usable in this case, the court determined the compensation for the infringement in a manner that reflected both the market approach and the income approach. The court put emphasis on the negotiation power of the parties and applied the hypothetical negotiation which is a recognized price setting method both in transfer pricing practice and in legal praxis of intellectual property. It means that the court sought to set the compensation as if the parties had negotiated it in willful market situation and then split the compensation to the parties. Thereby, also the income approach and the profit split method got reference in the case law.

Also the three interviewees strongly argued on behalf of the market approach. Mr. Kaikkonen commented that in legal praxis the market approach -based thinking and the hypothetical negotiation is generally the starting point to determine compensation for infringement. Mr. Henshall and Mr. Karjalainen, in turn, commented that also in transfer pricing the market approach is the preferred approach due to the arm's length principle. From the transfer pricing methods, the market approach refers to the CUT/CUP method. However, the previous discussion on the matter predicted that the application of the market approach and the CUT method would require a very high level of comparability between the transactions in comparison. The expectations included that if the comparability couldn't be met the income approach would be applied instead of the market approach. The income approach, however, didn't get much direct evidence in case law examination as only one case discussed the question. However, the weak support for the cost approach implies that the income approach turns out to be the second best approach to valuate intangible assets.

The required level of comparability is the point where the findings of this study differ from the expectations. The expected outcome, which was based on previous transfer pricing discussion and case law examples from other countries, was the comparable transactions to be almost identical in order to be useful. Finnish intellectual property case law evidence, however, differs from the expected outcome. The study showed that intellectual property case law in Finland accepts a lower level of comparability between a transaction in question and a third party transaction. In these cases, the court uses the market price, even though not perfectly comparable, as a benchmark price. It then adjusts this price to better correspond the situation. The use of the market price so extensively as a benchmark is definitely a surprising

outcome in the light of similar studies made in other OECD member countries in where a very high level of comparability is required in order for the comparables to be useful in applying the market approach. The difference may derive, as Mr. Karjalainen and Mr. Kaikkonen commented, from the fact that in Finland case law does not have an equally significant role in forming and developing legal praxis than it has in the Anglo-Saxon countries. The role of case law in Finland is more in interpreting the law, not so much in forming it. Therefore, in Finland, the court may have more flexibleness to interpret the law and to adjust its decisions according to each case without considering the decision as a creator or developer of new legislation.

All things considered the research on intellectual property case law in Finland provided evidence that between third parties the market approach is the most appropriate valuation approach over the income approach or the cost approach. If exact comparability cannot be met, market prices, however, may be used as benchmark prices to set the actual price of an intangible asset. In the case that the market approach despite benchmarking is not suitable for the situation, the income approach is the second best approach. The income approach did not ascend to the second place because of strong direct evidence in intellectual property case law but rather because the cost approach didn't receive any evidence in its favour. On the contrary, all the interviewees saw the cost approach as the least suitable approach to valuate intangible assets both between unrelated parties and related parties. From the transfer pricing methods accepted by the OECD, the comparable uncontrolled price/transaction method, the CUP/CUT method is the method that should be applied in transfer pricing transactions involving intangible assets. In the case that the market approach is not suitable, even with adjustments, the income approach and the transactional profit split method is to be applied. The application of cost approach -based methods didn't get any support from the case law.

### 9.5. Convertibility of foreign case law decisions into Finland

This study showed that intellectual property case law in Finland may serve as an important reference in analyzing transfer pricing transactions involving intangible assets. However, the study also found that intellectual property case law in Finland is still in its infancy and there are questions that intellectual property case law in Finland has not answered yet, or there is only very little evidence regarding the matter. These questions include the question of the scope and ownership of intangible assets and the importance of the income approach in the valuation. Hence, at this point interesting question, that could also be a relevant question for

further study, is whether case law decisions made in other OECD member countries[163], could be used as a reference in solving questions that the Finnish case law has not answered yet? It is obvious that intellectual property case law decisions made in other countries are not binding in Finland. However, as intellectual property legislation between TRIPS agreement countries is fairly identical, it could be expected that foreign case law decisions would serve at least as a reference in Finland as well.

The use of case law decisions made in other OECD member countries as a reference in Finland depends upon if asking the question from transfer pricing experts or intellectual property law experts. In the interview of Deloitte's transfer pricing partner Mr. Jukka Karjalainen, Mr. Karjalainen argued that even though foreign case law decisions are not binding under the Finnish legislation, they serve as a reference in Finland as well. Mr. Karjalainen commented that as transfer pricing is a highly international topic, in transfer pricing practice in Finland he wouldn't easily make decisions that are against case law decisions made in other OECD member countries. As an example Mr. Karjalainen used the Uniloc USA Inc. et al v. Microsoft Corporation case regarding the use of rule thumb. As the use of the rule of thumb is considered "fundamentally flawed" in determining a reasonable royalty rate in the United States he would no longer apply the rule of thumb in transfer pricing practice in Finland either.

Intellectual property lawyer Mr. Henri Kaikkonen, on the other hand, was more cautious about using foreign case law decisions as a reference in Finland. Mr. Kaikkonen argued that despite intellectual property legislation being fairly similar across the TRIPS agreement countries, legal praxis in Finland is not very inclined to take an example from other countries. Mr. Kaikkonen commented that to some extent Finnish legal praxis takes into account similar case law decisions took in other Nordic countries, especially cases solved in Sweden. However, Mr. Kaikkonen would be more cautious than Mr. Karjalainen in using case law decisions made in the Anglo-Saxon countries like the US, the UK or Canada as a reference in Finland. Though considering the different point of views of the interviewees it should be noted that Mr. Kaikkonen's view is that of an intellectual property lawyers, perhaps even practicing in front of the Finnish courts, whereas Mr. Karjalainen's view is more towards the application of the principles laid out in the foreign case law in the transfer pricing practice.

[163] As for example Jay-Lor v. Penta and Uniloc v. Microsoft Corporation

As similar studies to this study, that use intellectual property case law to solve transfer pricing disputes, are so far not very widespread study perspectives in transfer pricing, comparative study to other Nordic countries whose legal environment is more alike to a Finnish one cannot be made. Transfer pricing practice, so far has not confronted any intellectual property case law decisions from Sweden or other Nordic countries that could be used as an important reference in transfer pricing in Finland. In the case that similar studies will be made in other Nordic countries, comparative study between the Nordic countries would be an interesting research topic for future study.

### 9.6. Implications of the findings on current transfer pricing practice

The paper has demonstrated that intellectual property case law in Finland has faced largely the same questions that are now under debate in the transfer pricing arena. Therefore, by following the arm's length principle the results discovered in legal praxis should be applicable in transfer pricing as well. The findings found in this research support many current practices of transfer pricing and, thereby, they do not change dramatically the actions taken in the current transfer pricing practice. The results, however, clarify the role of the comparable uncontrolled transaction method and the transactional profit split method in setting a transfer price of an intangible asset and discourage the use of cost based methods. The most striking result of the study is the absolute requirement of evidence in valuating soft intangibles and the lower required level of comparability in applying the market approach. They are the findings that may impact the most on current transfer pricing practice.

The findings of this research, however, have limitations. The biggest limitation is the relatively scarce amount of evidence. The research comprised 14 cases, which 12 of them were the Supreme Court's precedents and two Court of Appeals' decisions where further leave to appeal to the Supreme Court was not granted. All of the cases gave evidence for the market approach whereas some findings of the research were only supported by one or two cases. Even though already a small amount of the Supreme Court's precedents and the Court of Appeal's decisions have huge importance in forming appropriate practices in legal praxis, the results of this study should be interpreted bearing in mind the relatively small amount of evidence on certain findings. Nevertheless it is important to keep in mind, the comment of Mr. Karjalainen, that the case law decisions are not necessarily needed to answer each directly comparable situation but rather to lay down the accepted principles. And that is what I believe this study has managed to provide for the reader.

The credibility of the case law findings also increases along with the expert interviews. As seen in the empirical part of the paper, the comments of the interviewees are much in line with the case law findings. Expert opinions have increased importance, particularly in transfer pricing where the theoretical basis is limited and the practice has an important role in forming accepted practices.

All things considered, the conclusion is that intellectual property case law gives valuable information to the transfer pricing arena on how disputes regarding intangible assets are solved between third parties in Finland. The findings of this research are therefore valuable if Working Party No. 6 and transfer pricing practice decide to use real-life, third-party examples in solving transfer pricing disputes regarding intangible assets.

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INTERVIEWS:

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