

realized that with the cash raised, she could be ambitious and perform her version of retail trial and error at a larger scale. She ultimately found Phil to be an invaluable advisor and did not mind him becoming a permanent fixture at MSell.

One time, while she and Mr. Siegel were reviewing the monthly close, Phil stopped by her office. He complimented the accountant for the work he had done pulling together the deal. "Great job," said Phil, "I know you do not perform this type of work often, but you held your own going against my advisor."

While Karen Wu despised Phil's patronizing ways, the man had seen a lot in his years and had earned his bragging rights. Phil continued, "Mr. Siegel, you should tell us about your plans for corporate taxation. I'm sure you must have a few things planned or even already underway."

From the frozen appearance on Mr. Siegel's face, the CEO knew that her accountant had nothing planned. She quickly evaluated whether he had lived through his usefulness. Earlier that year, in fact, she had secretly requested Amy to shop around for a potential replacement. They both realized that he would sometimes be out of his depth, but bringing in a larger accounting and tax advisory firm would definitely increase their fee expenses.

He had only a tepid response to Phil's probing, "We do the best we can, Phil. And with our expansion and increased interest expenses, we are not likely to pay taxes in the near future." It was obvious that he had not thought much about tax planning for MSell.

"For now only," Phil countered, "In the future, we will return to even higher levels of profitability. We need to put in some plans to defer taxation on our profits, no later than our exit event."

"But how," Mr. Siegel asked, "MSell's operations are all domestic and I can't see how we can defer corporate taxes, unless we consider some untoward tax shelter."

Hearing the word "shelter," Karen Wu perked up.

"Yes, we sell everything here in the United States," Phil responded and, turning towards the CEO, continued, "But all of our merchandise originates from abroad, right, Ms. Wu? We buy almost everything from your native China, do we not?"

Karen was now doubly irritated by Phil's references to her ethnic origins, in addition to his patronizing attitude, yet everything he said was true, so she thought it best to just nod.

"So, you see, my dear Mr. Siegel, our entire supply-side is outside the United States. I would say sharpen your pencil and start thinking about taxes because Ms. Wu here will soon more than double our sales and profits. Neither we nor our future shareholders would want to see the government tax away a third or more of what we make."

Feeling obliged to say something, Karen added, "I would rather focus on profitability and let Mr. Siegel handle the taxation of those profits."

"Very well put. While I don't claim to be an expert in corporate taxation, not like Mr. Siegel here, I can tell you what I learned over the years as a corporate executive. The U.S. corporate tax system starts with the premise that each U.S. corporation and its subsidiaries are subject to tax on their worldwide income. From that starting point, there are certain exceptions for deferring current taxation. For example, if MSell were to have a manufacturing plant in China, held in a separate Chinese corporation wholly owned by MSell Corporation, the income of that Chinese corporation would not be subject to tax in the U.S. unless it is brought back as a dividend."

Mr. Siegel interjected by pointing out that the entity would be subject to tax in China, "But at a lower rate than the U.S., the last time I checked," Phil quickly added, pointing out the lower corporate tax rate of 25 percent in the People's Republic of China in contrast to the 35 percent rate in the U.S.

He continued, "That was just a hypothetical example. I can't imagine MSell would ever want to manufacture for itself while there are so many willing vendors, competing fiercely to supply us. Regardless, my point is that our operations are inherently international because what we sell is made outside of the U.S., and the U.S. Tax Code allows corporations that conduct business outside the U.S. to defer income, under certain conditions. Of course, as it is, we cannot take advantage of any deferral, but I am sure Mr. Siegel or some other tax advisor can tell us what we would need to do."

Mr. Siegel volunteered to look into this matter and get back to them. The CEO felt the need to show that she was still in charge by suggesting that this should be delivered in a Board presentation format. "Great idea," Phil said, and quickly suggested a few advisors to Mr. Siegel to collaborate with. *Yet another useless thing for me to worry about*, Karen Wu thought. She hoped, in fact, that Amy would handle this matter with Mr. Siegel.

[From Karen Wu's point of view] Mr. Siegel's sometimes reluctant collaboration with an advisor from a big tax consulting firm, which we'll call ABC, recommended by Phil, became a fast moving and expensive exercise. The ABC transfer pricing specialist wanted to know the business strategy. This, in turn, opened a series of discussions involving Phil, Karen Wu, and a retail industry specialist from ABC.

At times during her discussions with them, she felt defensive as she had not thought through many issues they raised about the company's expansion. The main disconnect was about her designers and buyers. Heretofore, Karen had relied on her own judgments and a handful of assistants working with vendors to develop the products. The advisors had trouble believing that she was able to do everything with so few people. They assumed that while such a lean staffing model could have worked in the past, it would no doubt prove ineffective in the future.



a couple of minutes, Karen reentered the room to retrieve the materials she left behind, but decided to stay on to listen, standing by the door with her arms crossed at her chest.

Bruce drew three seesaws on the whiteboard, the first tilted to one side, the second in balance, and the third tilted to the other side. "The Global Principal concept is a separation of the retail and logistics operations from other core activities. As Ms. Wu indicated, the Global Principal would be the brains, but running the retail stores is a pretty much a neuromotor activity that may run along the parameters set forth by the brain. I also liked Phil's comment that the executive team may be geographically spread. In fact, I believe that to run a global enterprise, you would need to do that, recruit talent wherever available," taking a breath, the advisor continued, "I totally agree with your CEO that tax concerns alone should not dictate where you would locate your executives but, on the other hand, they should not be totally ignored. Let's say that you are evaluating two candidates for an executive position. One is located in the U.S. and has limited mobility, while the other can relocate anywhere. Wouldn't you prefer the latter because, if you choose to locate the Global Principal outside the U.S., he or she can relocate?"

Mr. Siegel's eyes were fixed on Karen Wu, who appeared to be newly calm and without so much of a hint of her earlier emotionalism, her arms now hanging in relaxed fashion by her sides.

The advisor, encouraged by her return, appeared to be more animated than his usual cautious self, "I drew these seesaws to give you an idea of how this Global Principal would work. On the first one, if we have most of our executives here, and only a few in, say, China, our center of gravity would be in the U.S.," he drew some stick figures on the lower-end of the seesaw and a lone figure on the higher end. "Moving over, if we have more or less equal numbers, we could have a split Principal, with the U.S. and China sharing the Principal profits," he drew three stick figures on each side and drew hair on two sitting on the U.S. side. "However, the whole concept of the Global Principal is not solely dependent on people. Let's say most of our people are in China and a few are in the U.S. Do we still need to split the Principal profits? Not necessarily. We could choose to have our Global Principal in China, but still have some executives here," illustrating his point by putting 4 stick figures on the lower China side and drawing 2 stick figures along the bar on the U.S. side. "What we do is to have the executives in the U.S. assisting the Global Principal in an advisory and consulting capacity, under the control of the executives in China, under a service agreement."

Phil chimed in, "We would require a few executives in the U.S. to run our retail operations, as well as in Europe and other places."

Bruce clarified, "Here we are just talking about the executives focusing on the IP development, namely, procurement, designs, and branding. You can have other executives focus on retail and logistical operations. Also, we are not talking about your highest level executives, the CEO or the CFO, as their main focus would normally be on the overall enterprise strategic management and shareholder relationships. To the extent they would participate in IP-related activities, they may be half- or quarter-time, or less."

"I can live with this. At the end of the day, we would need to focus our attention on international locations, likely to be China, or perhaps Hong Kong, and see where the talent showed up," Karen Wu chimed in almost happily.

"But it is not much of a guessing game. You must prepare the structure to make sure your overseas location ends up being the Global Principal," corrected the advisor.

Mr. Siegel cringed, why did Bruce need to go there?

Amy jumped in, "We asked you to give us a straw man structure to evaluate."

Bruce softened the impact with a smile and calm hand gestures, "Let's step back for a second. There is a great deal of work to be done here to determine exactly what you would need, where, and how we are going to structure the legal entities, as well as the activities of different executives. What we are trying to do here is to make a decision to see if a more detailed feasibility analysis is warranted. This is a multi-step process, with many gates. We just cleared the first gate, I guess, by understanding the importance of tax."

Phil raised the "why now" question. "I understand that it is best to get into these things from the ground floor. It's good to have our Global Principal in the best possible location up and running before we start building our new intangibles for the retail business, international expansion, probably more serious designing of our products, and perhaps brand promotion. If we start now, probably the income we attribute to MSell Corporation would be way lower than the perpetual five percent you are modeling. But the question I have is whether we can wait. What would happen if we do this one, or even two, years later? Would the income for MSell Corporation, the buy-in royalty, really go up that much more?"

"Sorry, Phil, but I just don't have a good answer for you. We have not really done any work to assess whether five percent is good, let alone how it will change if you start developing some IP in the U.S. and then move the development offshore. My general industry experience is that retail IP churns relatively quickly, just like software and high-tech devices. The only thing I can tell you is that this is not an all-or-nothing situation. If you start something in the U.S. followed by increased participation from China, you still get a benefit; it would be less than if you started out of China right away, but you would not lose everything."

Mr. Siegel was a bit jaded with this argument. "Are you really comfortable with that position? As you know, or you may have even told this to me, the IRS regulations and the proposed rule-making from the OECD for international usage are all making migration of intangibles more difficult?"

"Yes, Mr. Siegel, generally speaking, you are correct. Tax administrations and, to some degree, the OECD may have taken the position that once an IP idea is formed, its full potential belongs to where it was discovered. This may hold true for some industries that rely on discrete, path-breaking innovations, such as IT technologies. In MSell's industry, however, you are building IP one product or one vendor at a time. I don't foresee a path-breaking discovery at some point that would give MSell a long-lasting



"Steinhausen. It is a difficult one. But, yes, you can call me Phil."

"Okay, thanks, Phil. While I was worried at first, it checks out. For whatever reasons, states currently do not have a 364(d) analog, so it is possible to contribute intangible property to your subsidiary without triggering a gain. Look at it this way, the property is going to a wholly owned subsidiary, so the parent company contributing the IP retains an economic interest, but somewhat indirectly. And that subsidiary may not have nexus in the home state of the parent. So the intangible property is effectively expatriated from the home state, without an exit charge. The shares of the subsidiary are owned by the original corporation. All income earned by the subsidiary will ultimately come back either as dividends or as capital gain on an eventual share sale. Yes, there will be tax deferral on the income, but that is about it. Perhaps it is just one way the states are trying to get along with each other instead of more closely regulating such activity."

The new tax director continued, "States don't want to get into the details of the valuations on such IP contribution transactions. Even the IRS is having a difficult time trying to keep up with those."

"I can understand the original IP transfer being a capital contribution, but from your presentations it sounds like as we develop new IP, MSell would automatically be contributing those to the Nevada Corporation. In effect, MSell would not get any benefit from its ongoing IP development activities. Don't the states have a requirement to deduct expenses? How could MSell deduct IP development expenses while all the benefit would go to the Nevada corporation," Phil asked.

"By netting, MSell pays a net royalty."

Phil replied, "Never in my long years in business have I heard of a net royalty. What does that even mean?"

Jay explained, "I think the idea is that MSell pays a discounted royalty rate for agreeing to conduct development activities. Think of it this way: Once Nevada has the IP, it can charge a full royalty to MSell because MSell really needs the IP. Say 10 percent of sales is the full rate. But then if MSell is spending, say 5 percent of sales, for IP development, then Nevada says, 'I am going to charge you only 5 percent royalty, but you must take care of IP development.' That is what it is, so MSell's IP development expenses are necessary expenses because MSell gets a discounted royalty rate."

"That may work. It's just that you will never have such a license in real business would you?" To which there was a pause.

Phil took it as a sign that he was thinking of an example but, as the silence extended into an uncomfortable length, he felt obliged to respond, "Sorry?"

"Yes, Phil. Did you have more questions?"

"No, but I would be curious to see what your tax advisors think about this net royalty concept."

"Sorry, who are they?"

"Who?"

"Tax advisors."

"Your tax advisor, or transfer pricing advisor, whoever is advising you on this project, or are you doing this all by yourself?"

"Not entirely alone; I will, of course, ask my friends to see how they handled theirs. In fact, I came across this idea through an ex-colleague."

"It is up to you, but I would strongly encourage you to seek professional advice on this matter."

"But I cannot. You obviously aren't familiar with the size of my department's consulting budget."

"Ha, no, I'm not."

"Not surprising, because it is a big zero. My only outside help is what I can get from Mr. Siegel as part of the tax provision review for audit. Poor guy, it must have been a shock for him to lose the tax compliance engagement; he was still nice enough to help, but there is no budget to pay him."

"But wouldn't this planning require a valuation study for the value of IP?"

"Not really, but perhaps a transfer pricing study to determine the royalty rate; a good friend of mine will help me put one together. We worked together on our first jobs in public accounting, so we are very close, and he is a super technical guy."

"That is not an easy thing to pull off on your own, even with someone's informal advice."

"My friend Jeff is a very capable guy, and we were very close. Our partner-in-charge used to call us Captain Kirk and Mr. Spock, after the *Star Trek* characters. I was Captain Kirk, being the one with the practical knack for things. I would figure out what needed to be done, and he would come in with the Code sections and technical details. We were a great team, promoted to managers together, but then I left for industry, probably a little too early. Now Jeff is an international tax director at Diversified Industries, a Fortune 100 manufacturing conglomerate – they have a hand in many things, except retailing."

"I don't know how I feel about my company getting unpaid tax advice. Not very well, actually. You know what, I have some guys I know from ABC."

"I may know them too, if they were the ones on the BStore account. You know that I was at BStore, too? Of course, I never got to know the C-suite folks, like you."

"Yes, actually, you may well know them. Did we have this type of state tax planning at BStore?"



this assumption with the reconciliation process and convinced himself that the customs value must be the price at which he sells his merchandise and that he should flag for reconciliation, as he may not know the final sales price to Canadian customers.

On the call with the customs broker, he explained his analysis. There was a long pause, after which the customs broker shared that he had never heard of any company following such a practice. There was no commercial invoice because they were not selling the goods across the border, but rather MSell was transporting its merchandise into Canada. The customs broker reiterated, "You do not have a commercial transaction when you ship the goods, because you simply cannot sell goods to yourself. All that is required is that you assess the value of the goods. Your accounting records should indicate the value at which MSell acquired the merchandise. In fact, the typical practice for a company shipping goods to its own branch would be to declare them at the inventory value."

But the customs broker provided a caveat, "If you have transfer prices established for your branch, even if there is no commercial transaction, companies sometimes use the internal transfer price for customs value declaration. That way, they confirm that the customs and tax treatments are the same."

Erik asked the broker whether they should have a transfer price. The broker excused himself and said that he was not a tax expert. Unsatisfied, but decidedly curious, Erik tried to educate himself on transfer pricing. He happened upon some pages in corporate taxation books, where he read and reread the definition, "When entities under common corporate control transact across tax jurisdictions, such transactions are subject to the transfer pricing regulations." Yes, he pondered, he was in fact the MSell's Canadian branch and was under common control with MSell because he was part of MSell. But as the customs broker said, the problem rests in the fact that he did not have any transactions. His next step was to call headquarters to speak to their tax director, Jay Patel.

The tax director had only limited international tax experience, but his transfer pricing advice was simple, "When I dealt with this before, I asked the business folks to set a fair price when they sell to each other. I think that is the appropriate way. Otherwise, if you use the transfer pricing methods, it is a lot of work and you will at best get some artificial prices. The only transfer pricing we did was with respect to an IPCO here in the U.S. and my dealing with transfer pricing was expensive and, to tell you the truth, somewhat unconvincing to me."

Erik then asked about taxes in Canada. Jay's answer was that they had already registered for tax with the federal government and with the provinces, "When the time comes, just like we do here for all the states, we will file the Canadian federal tax return, as well as the provincial returns."

Erik wanted to meet with the advisors, but the tax director convinced him to hold a conference call instead, to keep the costs down. In the call with Bruce Balaban and his Canadian colleague, Erik asked about transfer pricing. The tax advisor's answer was

somewhat confusing, "Because you are a branch, you only need to report sufficient profits in Canada and you will be okay."

Erik pressed the issue, "But how do we know how much is sufficient profits in Canada to meet the arm's length standard? Is there a safe harbor? Is there a government issued formula to calculate the acceptable level of profits?" After a bit of head scratching, the tax advisor suggested the need for a transfer pricing study to determine the minimum level of profits to be reported. Jay was not convinced, "We are just starting the business and cannot afford a study. Why don't you advise us on a profitability rate that is somewhat on the generous side, and we will go with that."

At that time, some 15 years ago or so, when combined with the provincial taxes, the Canadian tax rate was higher than the U.S. statutory rate of 35 percent. Any income earned by MSell Corporation's Canadian branch would have been reported on MSell Corporation's U.S. federal tax return because, as discussed earlier, all U.S. corporations are subject to the U.S. tax on their worldwide income. To avoid double taxation, however, the U.S. Tax Code allows taxpayers to claim a credit for the foreign taxes paid. Accordingly, taxes paid in Canada could have been potentially credited against the U.S. tax liabilities up to the U.S. statutory tax rate. To further buttress his position, Jay added, "My reading of the U.S. Treasury Regulations is that the Section 482 [Transfer Pricing regulations] does not apply to a U.S. taxpayer's transactions with its branches." This was not entirely accurate. The rules apply, but there is no documentation requirement for transactions with branches.

It was agreed that the accounting firm would not run a full study but would put together a simple memorandum advising MSell on a minimum level of taxable profits to report, based on Canadian transfer pricing principles. Jay also suggested that they may be able to leverage the study prepared for the state tax purposes.

Let's consider an example. If MSell's Canadian branch reports a taxable profit of \$1 million, it would be required to pay Canadian corporate tax on that income (federal plus the provincial corporate income taxes). For simplicity, let us assume that on a combined and average basis, MSell's Canadian tax rate comes to 35 percent (which is a fair assumption for the 1990s). MSell would then pay a Canadian corporate income tax of \$350,000. For its U.S. federal tax return, MSell would report all of its profits, including the profits of its Canadian branch. Let us assume that MSell's total taxable income for that year was \$10 million (including the \$1 million from its Canadian branch). On that taxable income, MSell would be required to pay U.S. income tax of \$3.5 million. Under normal conditions, MSell could claim the Canadian tax of \$350,000 as credit against its U.S. income tax liability and would pay only \$3.15 million in U.S. taxes.

From this example, it is easy to see Jay's logic: If MSell generously reports \$2 million in Canadian taxable income and pays \$700,000 in Canadian taxes, it may still be able to get a credit against its U.S. taxes. There is a problem with Jay's approach: One of the



"We will be much closer to your Canadian look," the European architect explained, "but adding more European references to sculpt a European identity for MSell. The two transatlantic versions of MSell will feed off of each other, and we will evolve into a dynamic global brand." Amy was not against having a new European theme, but was concerned that they were missing the point of the European expansion – which, in her mind, was to create more sales volume for the same merchandise sourced from the same vendors. Developing a new product portfolio would prove too costly. Nigel and the architect reassured her that they did not have any plans to deviate from a global merchandise portfolio approach. In the end, Amy Parker also agreed to expand the global portfolio, without differentiating it on a regional basis. The idea was to add a generational link twist. The store would be welcoming to Millennials, Baby Boomers, and their children, as well as to their children's children. The only real challenge would be to develop product designs for the Generation Y customers. All else being equal, Nigel wanted more independence for Europe, and he would later hire buyers and designers there to develop more products to be added to the global merchandise portfolio. Karen Wu welcomed European-inspired new product additions, but insisted on selling all products in all stores. *Always a global merchandise assortment* was her mantra.

As the European expansion launched, CFO Amy Parker consulted with Jay Patel, the tax director, on the legal entity structure in Europe. Jay described the holding company structures he had seen: They would incorporate a European holding company in a jurisdiction that does not impose tax on dividends received from subsidiaries, has a good treaty network to reduce withholding taxes on incoming dividends, and does not impose capital gain tax on sales of subsidiary companies. The holding company would incorporate a subsidiary in each country where they would open stores. He explained the concept of the U.S. tax branch rules. U.S. tax law allows companies to treat foreign subsidiary corporations as if they were branches, which makes the U.S. tax filings and calculations easier.<sup>1</sup> Jay's suggestion was to treat all subsidiary corporations of the holding company as branches of the holding company for the U.S. tax purposes. He explained that if they expect to have a long period of losses in Europe, they may even want to treat the holding company as a branch as well, to allow the losses to flow into the U.S. tax return.

"I know no one wants to plan for losses, but I presume it is a possibility in this instance."

"What if we do not," the CFO inquired.

1. Informally known as the "check-the-box" election, U.S. tax law allows taxpayers to effectively consolidate their higher level foreign or domestic subsidiaries into their lower level subsidiaries, without affecting the legal standing of the subsidiaries from commercial and local law perspective. The regulations on what type of legal entities can be treated as branches, and other complications arising from tax branch selections for entities in different jurisdictions, can be quite complicated. In general, the tax branch treatment does not impact how transfer pricing is done, but a transfer pricing practitioner should be aware of the taxpayer's check-the-box elections as he or she discusses potential allocations of risks and functions.

"We can defer the U.S. tax on the dividends from the local countries. The dividends come up to the holding company and stay there without further U.S. taxation until we bring in a dividend from the holding company."

Amy asked whether they would be able to get foreign tax credits. "Yes, we will get credit for the taxes paid by the local subsidiaries, but we may end up paying top-up taxes if they are lower than U.S. rate of 35 percent, which will definitely be the case for the UK." The CFO understood the decision in front of them, but could not decide which way to go. MSell had always been successful and the expectations were that the European stores would be profitable, except for their first year or two. With this expectation in mind, she decided to go with the holding company structure, but without making an election to treat the holding company as a tax branch of MSell-US. Even thinking about the possibility of failure and losses was not in her DNA.

As the stores throughout Europe were leased and remodeled, Amy called on Jay to provide guidance on transfer pricing. As he did in Canada, Mr. Patel wanted to consult with Nigel Frogett. The CFO, however, had a different thought, "Let's not involve the operations folks. Last time, those ABC advisors billed me dearly for their transfer pricing advice to Erik. Had you been in charge, we would not have incurred any fee. Also, the business should not really care about transfer pricing. They should try to make money for MSell, not for any specific legal entity."

When he learned that he could not have a real consultant, the tax director independently decided to seek out Erik's counsel. Although he had initially irritated him, in the end, Jay had actually enjoyed working with Erik and had benefited from his enthusiasm in setting the Canadian transfer pricing policy. He was hoping for a repeat experience with Nigel but, apparently, such was not the case. He was on his own this time.

He began by arranging a chat with Erik about different options he had considered for Canada, which went as follows:

#### Real World Box 5.1

##### Erik's Notes on Canadian Transfer Pricing

*Q: What are the options for MSell-Canada's transfer pricing?*

*Three options:*

- *Use external benchmarks (TNMM). Select comparable companies: independent retailers, with public financials (SEC 10-K filings). Calculate the comparables' margins. Set our transfer pricing to target their profitability. Must have our projections to set prices, but adjustments can be made.*
- *Resale Margin Method. Benchmark controlled retailer's margin (MSell-Canada) based on its direct purchases from unrelated suppliers. MSell-Canada may buy directly from third party vendors. Need comparability on type and range of products, volumes, warranties, and payment and shipment terms. Usual problem*



"So we are free to design the transaction as we see fit, but finding good industry benchmarks is necessary for pricing. So while you can do as you wish, at the end of the day, you will be limited by the availability of the benchmark. Is that the received wisdom?"

"I think so. If you have a single aspect of the transaction that differs from the benchmarks, say your benchmark distributors do not assume the warranty risk, but you want yours to do so. The challenge would be to isolate the return associated with that single risk."

"You mean if you deviate from your benchmarks, you may not have benchmarks anymore?"

"That is little extreme. In some cases, you can make adjustments. For example, on the warranty risk, you can look at historic warranty expenses on an average basis and add an appropriate premium to quantify that risk. But when you look at product liability risk, where the track record is less indicative of the future, it may be more challenging."

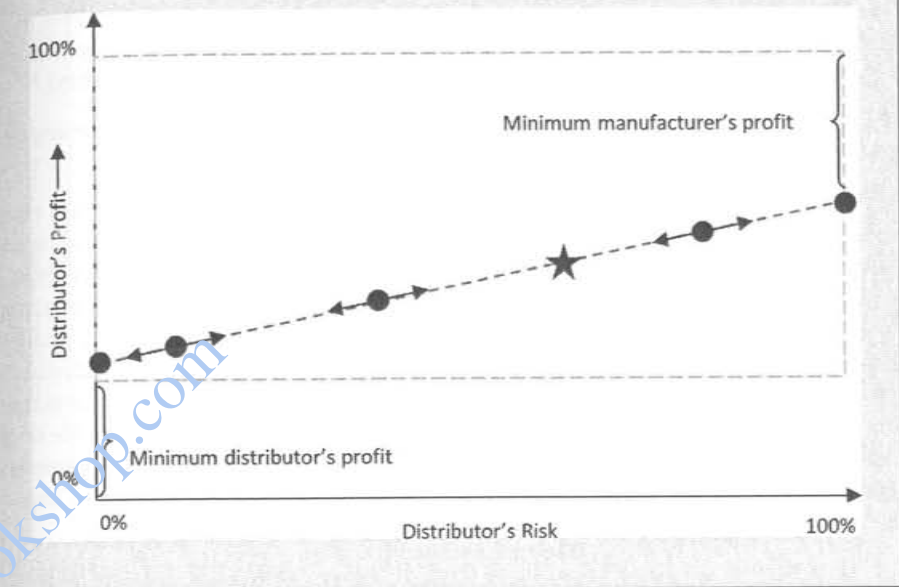
"Then my approach was not that far off. You did not seem to be appreciating it, but that is how we approached it: we looked at the potential benchmarks. I guess we can perhaps tweak a few things around those benchmarks to allow for a few variations from the benchmarks."

Jeff pondered this for a moment. While he appreciated Jay's practical mind, he also wanted him to appreciate his more principled approach. He grabbed one of the cocktail napkins and drew a graph, showing the risk-return tradeoff for distributors (see Real World Box 5.2). The vertical axis represented the expected profits of the distributor. It maxed out at the consolidated profits of the manufacturer and distributor. The horizontal axis represented the relative risks assumed by the distributor. At the origin (meaning zero return for the distributor), the distributor assumed no risk and performed distribution activities in return for a service fee. That would be the lowest level of return for the distributor – only a functional return associated with performing distribution activities. If the distributor assumed all risks and the manufacturer was reduced to a toll manufacturer, then similarly there would still need to be a service fee paid to the manufacturer for covering the labor, depreciation, and overhead associated with the manufacturing activity plus a profit element.

Jeff picked a random point on the solid line (marked by the star in RealWorld Box 5.2), "Let's say you want to be here. The issue is that you have a limited number of benchmarks." He put three dots on the line representing available benchmarks. "Perhaps you can do some analytics to add or take away a specific risk or two." He drew two-sided arrows originating from his benchmarks. "The bottom line is that you can still choose your place on this line, but not every point is available because of the lack of benchmarks to support the appropriate return for that level, not with enough precision anyway. If your product, like our Plastimold, carries relatively large margins, there will be a lot of variation in attributing returns."

## Real World Box 5.2

## Supplier-Distributor Risk-Profit Sharing



Jay took the napkin and asked a few questions. He was once again impressed by his friend's analytical prowess. He had always been fairly content to play Captain Kirk to his friend's Spock, but now he felt a level of self-doubt and inadequacy. He took a deep breath and tried to take the initiative. Pointing out the minimum distributor profit, he said, "That is where I want to be. I do not want to show a lot of profits in my distribution jurisdictions." Jeff looked thoughtful and did not immediately respond. Jay continued, "Does that mean I will need to leave zero risk at my local countries?"

Jeff took a long sip of his beer, "To get there as a retailer may not be that easy. As I mentioned, at that point the distributor is essentially a service provider. It does not hold any inventories and does not have any receivables. In a way it functions as a commissioner, but instead of a percentage commission receives a cost-plus fee for its services."

"Of course, I cannot be a retail commissionair."

"Unless all you have at your retail location are merchandise samples and computer terminals to take online orders, which is the best way to reduce retailer profits."

"Is there a way to relax the model?"

"Rather than owning inventory, your retailers can take flash title only, when the goods are being sold to its customer. Basically, the manufacturer or the supplier will own all



they now purchase products from unrelated vendors at only the manufacturing cost, without incurring any design, or selection, or sourcing efforts."

"Have you ever had a situation like this before?"

After a moment's pause and a sip of beer, Jeff remembered an example, "Yes. We had this relatively small, but geographically dispersed bulk gas processing business that was put up for sale. Our CFO asked me to clean up tax matters including transfer pricing. It had never hit my radar screen because they had no reported intercompany transactions. I grabbed by transfer pricing advisor and had a meeting with the business unit CEO. The bottom line was that their customers always wanted them to set up a gas processing facility just next to their plants, to minimize transportation costs. Once they had a customer, they would negotiate deals to be their on-site gas processors anywhere around the world. They had a superb posse of roving engineers who would set it up anywhere and train local talent to run the gas processing facilities. They would set up a separate legal entity for each facility, collect revenues from the local customer, and keep the profits locally. Can you imagine? They were paying nothing for technical support, technology, for having got the customer contract in the first place."

"It sounds like a landmine," Jay added, "How did you diffuse it?"

"Let me tell you, Jay, it certainly became a big issue. Potential transfer pricing exposure was running in the tens of millions, taking a big bite out of the enterprise value. To shorten a rather lengthy story, we concluded that each gas processing facility was nothing more than a routine operation. They only purchased the equipment and manned the facility. We put royalties in place and then applied for a series of bi-lateral APAs."

"You mean advanced pricing agreements?"

"Yes. We first applied for one between U.S. and Australia, then followed up with one between U.S. and Canada, and then went over to Europe for the Netherlands, Germany, and France."

"That must have cost you a fortune," Jay gasped.

"It was a bargain, compared to the tax exposure we mitigated."

"Should I do an APA, too?"

"Frankly, I think it's too early for that. You just don't know what you may end up doing, that is, you'd don't know what you don't know. As a general rule, I would not use APAs as a substitute for tax planning. I went the route of APAs for our gas processing business because that was the only credible way for me to limit our exposure."

"So you effectively combined everything into a royalty charge. Why didn't you separately charge for customer relationships, technology, and technical assistance," Jay asked his friend.

"First of all, that would have been too much work," Jeff chuckled, "Just joking, I never run away from hard work. The reason is mostly found in the regulations and OECD Guidelines. The bottom line is that you must pursue the most 'reliable' analysis. For me, that was benchmarking these gas processing facilities that were doing nothing out of the ordinary. They were like franchisees. They actually did less than a franchisee because they did not have to sell anything – the customer contract was pre-set. They only had to run the facility."

"Do you think the same approach would be applicable in our case?"

Jeff paused before replying, "I would say it is up to you. If you prefer, you can fund all market development, store planning, merchandise selection out of the U.S., and then say that your retailers are simply running the stores to sell the merchandise you, I mean MSell-US, selected in the manner ordered by MSell-US, at the pricing points dictated by MSell-US. Then I do not see any reason why you cannot do what I did: Benchmark your local retail operations and have them pay any excess profits over to the U.S. as royalties. A note of caution, though, some European countries do not like such variable royalty arrangements. They prefer to have a license agreement with a fixed royalty for a period of three years or longer."

"That is a good thought, let me make a note of it," and Jay literally scribbled his notes on the back of a napkin. He asked a few questions to fill the gaps, such as the reference for the requirement to pick the most reliable method (Treas. Reg. §1.482-1(c)(1) and OECD Transfer Pricing Guidelines Para. 2.1 through 2.11), and the criteria (availability of reliable data, degree of comparability of the benchmarks, and potential adjustments required for the application of the method).

Jeff added that although it was not in any of the regulations, Occam's Razor principle<sup>4</sup> is the single most useful tool for method selection. "If two different methods are applicable for the analysis of the same transfer pricing problem, go with the simpler one," Jeff advised his friend.

While Jay was going through his gyrations to determine a way to develop the new internal business model for Europe, Erik spent a few anxious hours after receiving an email from Karen Wu requesting him to come to New Jersey the following week. The seemingly simple request made Erik giddy with anticipation. In his mind, by sticking it out in Canada and playing by Karen Wu's rules, he had paid his dues. Perhaps bigger and better things were finally awaiting him.

When Erik walked into Karen Wu's New Jersey office, he found her mulling through an assortment of photographs spread across her desk, each depicting different groups of Chinese children. Happening upon this scene, he realized that he knew very little about Karen Wu's personal life. She looked to be of an indeterminate early middle-age, of medium height, and slim. Her husband, Sam, looked haggardly and quite older. He

4. Occam's Razor principle is the view that among two equally compelling explanations, the simpler one is the better of the two.



## Services

They wanted to get started with services, as that seemed like an easier place to start. Jay requested a meeting with the advisor to understand the process. "This will be fairly straightforward exercise," Bruce assured Jay, "You have relatively few people in your headquarters, and even fewer of them are dealing with Europe. We will go through them one by one and figure out how much they are spending on Europe."

"You mean this month, or this year, or in a more general sense?"

### Real World Box 7.1

#### Conducting Service Cost Allocation Interviews

1. Please explain your role and responsibilities in the organization.
2. Which one of your regular corporate and operational duties concern European operations?
3. Indicate your role: oversight/ advisory/ reviewer/ task manager/ support/ perform tasks.
4. Do others in your organization assist you with your role? If yes, please explain their assistance.
5. If you were not performing your role, would European operations hire a person internally, or an external consultant to perform your role?
6. Please provide a measure of your time spend (as well as those assisting you) on each process/role (use % of time spent, or specific number of hours or days).
7. Have you worked, or will you work on any special, one-off projects assisting European operations?
8. Please explain the special project and your role in the project (oversight/ strategic direction/ reviewer/ task manager/ support/ perform tasks).
9. Do others in your organization assist you with these special projects? If yes, please explain their assistance.
10. Please provide a measure of your time spend (as well as those assisting you) on each special project (use % of time spent, or specific number of hours or days).

"Let me show you my typical script for conducting a services allocation interview." Bruce provided Jay with a list of questions, as seen above in Real World Box 7.1. Jay expressed his displeasure, "These questions are too abstract and open-ended. People will struggle to answer them."

Unsurprised by this reaction, Bruce explained, "That is why I need to be there to walk them through the questionnaire. Keep in mind, these interviews are partially to remind

people about things they may have done and may not recall immediately, as well as to understand their role for each regular process and special project."

"So this is basically an outline. You intend to fill it up by chatting with different executives. Is that the plan?"

"Pretty much," Bruce agreed.

"And," Jay asked, "You believe this is not something I can do on my own and provide you the responses?"

"I did not say that. Have you been involved in this type of exercise before?"

Jay quickly thought through different projects he had carried out throughout his career, "I used to supervise our R&D credit studies and would follow-up with researchers every year."

"But you probably had at hand what they said the year before."

"Yes, I had not done the original interviews, but just refreshed them."

"I think the same approach here would work well. We can go through the initial interviews together. You will then have the questions and write-up at hand, and can easily do the updates."

"How often does this need to be done?"

"I'd say that you should ideally do this every quarter, when things are fresh in everyone's mind, but definitely no less frequently than every year."

"You know what? I am probably one of the people you may want to talk to, right? Why don't you do your interview with me, so that I understand it better?"

"Okay, well, I know your role and responsibilities pretty well. So let's skip that part and let us talk about recurrent tasks you perform or monitor for Europe, such as reviewing tax returns, checking on filings, and so forth."

"Yes, I certainly do annual tax return reviews, provide information, and work with external advisors to file the tax returns. Every month, I review the VAT returns, estimated tax payments, payroll tax filings."

"Let me stop you there. What exactly is your role? Are you just reviewing them, or do you 'own,' I mean, manage the process?"

"Well, I will say, I am the task master. If I do not check on the service providers, no one would."

"It is more than a review?"

"I would say so. I provide some of the data, get the rest from others, and basically any and all things necessary to file the returns."

"Who else helps you?"



"In the first step, we need to understand how much of their total time and expenses go toward supporting Europe directly, as we normally do. For human resources, we just concluded that that is almost zero. Now we have to ask her to allocate her department's spend between support for headquarter staff versus North American store operations."

"How would we do that?"

"I can think of a couple of ways," Bruce suggested, "First, she can give us an answer based on actual time spent. If she does not have a good estimate on actual time spent, then we can review potential allocation keys, such as headcount, payroll totals, or whatever else she can come up with."

Upon her return, the human resources director announced that she had only ten more minutes. Noting this limitation, Bruce asked her how much of her department's efforts go toward supporting headquarter staff versus store operations. She gave them a nuanced answer, "Most of our time and efforts go toward recruiting, background checks, onboarding new hires, and terminations. In addition, we also deal with absenteeism, performance evaluations and issues, pay raises, and the occasional criminal manner, such as employee theft of our merchandise or assaults on customers. Normally, the headquarters staff is fairly well-behaved, but their recruitment and onboarding is more time consuming."

At this, the advisor floated a suggestion, "It sounds like the time spent on headquarters versus store operations is driven by the relative number of hirings and firings, headcount, and payroll. Let's take an average of all three."

"Think of it this way. Half of our time would be on recruitment, onboarding, and terminations. Our headquarters would hardly account for 5 percent of that activity. I would then say a quarter of our time is spent with performance and compensation evaluations, benefits administration, etc. For that type of activities, although we have fewer employees in the headquarters, they are higher-paid professionals and take more of our time. If I were to guess, I would say, 50-50 between headquarters and store operations."

Seeking clarification, the advisor asked, "Half of a quarter of your department's time and efforts are devoted to ongoing performance and compensation evaluations for the headquarters personnel?"

"Exactly, and we deal with employee-related problems in the remaining quarter of our time. That runs the gamut from prosecuting thieving employees to stern warnings on absenteeism, or arranging drug tests. I would say, the headquarters' portion of that would be no more than 5 percent."

"If you look back for the last 12-month period, how many hours do you think you and your department spent on misbehaving headquarters' personnel?"

"I remember that we have had a few complaints about work habits. I would say, altogether, it took perhaps a week of my time and that of one of my associates."

"Your department headcount was four, correct?"

"But these things are not predictable. We may have something big flare up, like it did a few years back when a workplace romance turned ugly. I was not the director then, but I remember the director and I spent almost a couple of months to sort through that. The last 12 months may have been exceptionally dull. I would just stick with 5 percent, and that is also the relative headcount."

Jay interjected, "But you mentioned that headquarters' personnel are better behaved."

"I might have. But I may have been wrong. Now that I think about it, human beings are human beings regardless of their pay grade. I think 5 percent is my final best estimate."

Bruce summed up the discussion, "So for the headquarters, we got 5 percent of 75 percent of your time on hirings, firings, and trouble shooting, plus 50 percent of 25 percent of your time on ongoing performance and pay evaluations. So a total of 15.75 percent of your department's budget goes toward supporting the headquarters."

"We do not use terms like hiring and firings. Also, please do not use a number like 15.75 percent – that makes it sound like we really had a scientific approach. My final word is that headquarters takes up 15 percent of our time, nothing more, nothing less. Sorry, but I am out of time, gentlemen."

Jay asked whether she'd be willing to review his write-up of their discussion, to which she replied, "Just don't put in 15.75 percent or terms I don't use, such as hirings and firings."

Following her exit, Bruce turned to Jay, "You do not always catch the people on their best day, which is why it's so important to report these interviews to get a good understanding of the facts."

"I almost felt like we should have rescheduled the interview. Perhaps I will just arrange something more relaxed with her to go over the write-up. Anyway, we now have 15 percent, what do we do with that?"

"First of all, we have people who directly manage or perform tasks, or advisory services for the benefit of Europe. For them, we have a percentage of their departments' costs allocable to Europe. We will take the weighted average allocated to Europe from such direct service departments and use that to allocate headquarters personnel support costs."

Jay drew a pie chart. "Let's say our total headquarter costs are \$20 million, which is where we would be next year. For argument's sake, let us assume that half of those costs are 'direct' costs, related to people who can directly support Europe." He split the circle in half and labeled the left one for direct costs. "If we determine that, say, the folks who make up this \$10 million of direct cost spend 20 percent of their time on Europe. We will say the direct cost chargeable to Europe would be \$2 million." He split off a slice from the left half with a dashed line.

"Then again, and for argument's sake, let us say that the remaining costs relate to 'support' activities. These activities are not directly related to Europe, but are for supporting our people in North America. To keep this manageable, let us say that half



"Kind of our situation in Europe, right?"

"Perhaps. Another type of arrangement is to license in a strong brand from a different field and try to extend it in your field."

"Give me an example."

"Let us say you want to have retail stores selling shoes. You have a pretty good idea about where to source them from, but just need a recognizable brand. You may go license the rights to a sneaker brand from a licensor who has no intention of branching out of athletic shoes."

"Wait a minute," Jay interjected, "You mentioned three types of transactions, right? Franchise, branded products, and trademark only (but from a different field). What about distributorship? I can buy someone else's branded products and sell them at wholesale or retail."

"You mean sell other's products in your own store format?"

"Yes, without designing or sourcing them. Is not that what category killers do? Buy from every supplier and sell in a store?"

"You can certainly do so, but that will not involve a licensing of intangibles."

"So you are saying that we should fit into one of the three categories," Jay sought to clarify.

"Not necessarily, but it would be good to do so." The advisor took a breath and continued, "You are similar to franchising, but we have already covered services and support component of the franchise fee through your headquarter service fee. So, we can think of your tested transaction as the licensing of a branded product and a store name. We can perhaps come up with a reasonable royalty rate using a combination of franchise rates and branded product licensing deals."

"Is there any other method?"

"There is a second method that looks at the bottom line profitability of the licensee, which works best if the licensee does not bring anything to the table. In such cases, you set the royalty so that the licensee makes a reasonable profit."

"How do you determine what is reasonable," Jay asked.

"In your case," Bruce explained, "We have already done that for your Canadian operations. We used the financial results of retailers that do not rely on their brands, value, and bargain product retailers, and also large franchise operators. Let's say that we determine that 5 percent operating margin – earnings before interest and taxes divided by net sales – is a reasonable level of profit for the MSell-EU. We then say that if you earn more than 5 percent operating margin, you will pay us the excess as royalty. We call that 'soak-up' royalty, because the royalty effectively takes away any excess profits the licensee makes."

"That seems like a practical way to manage licensing," Jay conceded.

"It would normally be, but there is a catch. You are planning to let your MSell-EU develop its local market. I know Karen said you would not advertise but, still, there will be the cost of starting up, establishing a reputation, and the like. Would you be willing to finance that market development and ramp-up from the U.S.? I just do not think so."

"How would we finance that, say, if we were to do it?"

"The easiest way, and the way that most companies do so, is to guarantee the MSell-EU a certain profitability level, say the 5 percent operating margin. But you can also identify specific spending items and fund those directly from the U.S. As I understand it, however, you would like to have MSell-EU do its own thing and make as much profit as it can. Because all else being equal, you prefer to have income in Europe, taxed at a lower rate. So if that is the idea, you would not want to take this approach."

They decided to consult with Amy to reach a resolution on this matter.

Amy was not very receptive. "I don't know why we waste our time thinking about ideas to bring more income into the U.S.," the CFO chided them.

Bruce Balaban tried to diffuse the tension. "We can also do a profit split. In the profit split, or rather known as the residual profit split, the 'excess' profits, over and above the benchmark return, are split between the licensor and licensee. In the residual split model, the licensee will still get its return, the 5 percent, but will also share in the profits over and above that."

Amy looked confused. "What good would that do?"

"Under the residual profit split, MSell-US and MSell-EU would share the profits, as well as losses; for example, the business was break-even before intercompany royalties ..."

"Losses? Why would have losses?"

"I do not mean to say that you will have losses ..."

"You just did."

"Sorry. Let me give you an example. Let's say that MSell-EU had zero operating profits before paying any royalties. Its target profit was 5 percent. If you take out that amount, then there is a loss of 5 percent of net sales. Now let's say the residual profit split percentages are 50-50. In that case, half the residual loss belongs to MSell-EU, which would be 2.5 percent of net sales. So, under this method, MSell-EU should earn 5 percent less 2.5 percent, which would be 2.5 percent of net sales and MSell-US absorbs the remaining losses."

"But where did the loss come from? Didn't you say we were at breakeven?"

"I did, but that was before the routine returns. If we are following the residual profit split, then MSell-US would make a payment to bring MSell-US's results to 2.5 percent operating margin, which is like sharing the risks. Remember, if we're doing a soak-up



For the license from MSell-US to the master licensee, we will use the current arrangement, with 5 percent royalty as a percentage of net sales. The master licensee will therefore take on significant risks with respect to the development of regional trademark intangibles and start-up, ramp-up losses and risks. So the residual profits would flow to the master licensee. Because this arrangement would require the master licensee to be able to control the risks associated with its activities, we will need to put Erik and Nigel and their support staff at the master licensee entity. You can also have other personnel at the retailer entities assist Erik and Nigel, for which the retailers will receive separate cost-plus reimbursements. Important thing to note here is that your operating headquarters for Europe are in the UK, which also happens to have the lowest tax rate among the major European countries. So this structure would be in line with your business model.

I have attached a diagram to this email for you to better visualize the transaction and payment flows. This may all seem complicated as I am trying to cram a lot into an email. If you are available, I can swing by sometime this week to have a quick chat about this matter.

Best,

Bruce Balaban

Jay printed the diagram:



Over the last six months, he had focused on his discussions with the lead tax partner from the audit firm and had ignored Bruce's pleas. After sorting his emails by sender, Jay realized that the advisor had been sending a similar email to him for about each month now, so he replied to one with a few potential date suggestions. When they met, Jay immediately launched into an inquiry about the finer points of Bruce's proposed model, "MSell-US licenses only the product and vendor lists to the Master Licensee, but then the Master Licensee seems to be sublicensing more than that."

The advisor agreed, "Correct. Under our current license agreement, each licensee obtains fully paid-up, perpetual, exclusive, local rights to trademark and know-how materials, and an exclusive, but terminable license to product selections/designs and vendor relationships."

"Yes, I know this. But we only executed the MoU, no license agreements yet, and I have just invoiced everyone for the year-to-date running royalties and management fees. We have not invoiced them for the upfront payments for trademark and know-how materials yet."

"You're telling me that you invoiced each one of the retailers separately?"

"Yes. Is that a problem?"

"Not if we move quickly. Under my proposed approach, the only license agreement will be between MSell-US and the master licensee and will cover the grant of rights for all of European territories, or even the rest of the world, except North America. Then there will be a sublicense from master licensee to European Retailers."

"And that is my question to you: In what way would that sublicense differ from the original license? Are we just going to do a back-to-back arrangement? If so, how would we justify different royalty rates in the license from MSell-US and the sublicense from the master licensee?"

"There are points of differentiation. First, the European Retailers will not make any up-front payments. Therefore, they will not have any fully paid-up rights for trademark and know-how materials, of course, if I can stop MSell invoicing machine. So they will sublicense any and all intangibles required for their business on an ongoing basis. Hence, the rights granted will be different."

"Then we have MSell-US charging the master licensee for management and support services, but the opposite is happening between the master licensee and the European Retailers, the charge going the other way."

"Let me explain it this way: MSell-US is a *pure* licensor, it only provides two specific intangibles: product selections and the vendor list. The royalty does not cover anything else. Therefore, whatever else MSell-US does for the benefit of the European operations must be charged to the master licensee."

"But the master licensee will not have any operations. Why would it pay a management fee? Should not the management fee be directly charged to the European Retailers?"



marketing VP was quite happy with that response, "This is our trend. We will need to go upscale because all of the other no frills competitors are on our tail. They are catching up with our cheaper, easier to make items, and flooding the market to the point that no self-respecting customer wants them anymore."

Back at her desk, Amy Parker saw that Karen Wu had called an emergency meeting to discuss the presentation. Amy gathered the materials to update their last analysts' conference call and discovered that her concerns were the same. She had no remedy at all, but was hoping that Karen Wu would have a new trick up her sleeve.

After reviewing the now familiar numbers, Karen Wu walked over to the window that boasted views of the Hudson River, albeit from the cheaper-than-NYC New Jersey side, "Amy, I will move to China to ramp up our procurement effort. We have been complacent for too long. We rely on our vendors to deliver innovative pieces, but anything we get from our vendors, everyone else gets too, sooner or later. We must have our own designers and buyers on the ground so we can get the pieces that fit the vision from our trend-spotters. We cannot do that from here, and I need to be the person in China, because that is what I am good at."

Amy was shocked, almost shouting, "But, you, you are MSell. You cannot *not* be the CEO."

"I could play the CEO game, but I am only as good as the next person in that role. In fact, store operations have never been my strength. Europe is doing fine without me, some say because of me not being involved. Erik even mentioned that fact recently. I think setting up a mish-mash stores in the U.S.," she paused, leaned her head forward, "Was a mistake."

"He is just an ignorant kid, does not know ..." Amy tried to console her.

Karen turned back to the table and, facing Amy, said, "I am the best when it comes to getting what I want from those vendors. I can show them how to make anything and everything." She paused, "I want you to launch a search for our new CEO. We will announce both our new strategy to expand in China and the CEO search during our call. Please set up an emergency Board meeting to get its approval."

When this news filtered down to Jay, he was working on the two or three sentences on tax to send to Amy Parker for the analysts' presentation. As far as he was concerned, taxable income had been growing steadily. Despite the fast growing, European operations, MSell remained a mostly U.S.-centric operation, with approximately 75 percent of its earnings in the U.S., subject to the 35 percent federal tax rate as well as to the applicable state rates.

Although 5 percent of MSell's earnings were in Canada, they too were taxable in the U.S. because Canada was a branch. If Canada had been a corporation, he might be able to defer taxation of earnings because the Canadian subsidiary would be making sales only in Canada. Under U.S. tax regulations, income earned from in-country selling of merchandise, regardless of the merchandise source (i.e., regardless of whether it is purchased from a related party or an unrelated party), may be deferred from current

taxation.<sup>1</sup> The company may have benefited from slightly lower tax rates in Canada. But, deferring income in Canada may not be a viable strategy because it would lead to accumulation of earnings and cash in Canada. If MSell were then to bring that income back into the U.S. as a dividend from MSell-Canada to MSell-US, the dividend income would be subject to the full U.S. corporate tax rate of 35 percent except for tax credits MSell-US may get for corporate taxes paid by MSell-Canada. Note that the tax burden, net of the foreign tax credits, is often referred to as "top up" tax, as the tax paid would normally be equal to the difference between the U.S. federal corporate tax rate and the foreign tax rate.

Currently, only 20 percent of MSell's profits were in Europe. Unlike Canadian profits, MSell had no reason to repatriate the European earnings; they could be used to fund the continuing growth in Europe. In accordance with this strategy, Jay was able to defer the U.S. tax on his European CFC (all local countries were checked into MSell-EUHQ). European tax rates averaged around 30 percent, giving him a 5 percentage point reduction on 20 percent of MSell's taxable income, or a reduction of 1 percentage point on his effective tax rate.

As for state taxes, Jay had deployed a standard planning tool often referred to as an "Intellectual Property Holding Company," or IPCo, for short (see Chapter 3). He had incorporated a wholly owned subsidiary of MSell in Nevada, where there is state corporate income tax, and contributed the registered intellectual property of MSell Corporation, such as trademark and copyrighted marketing materials, to the new subsidiary, thus forming an IPCo. Under federal or state income tax regulations, contributions of intellectual property or other assets from a company to its domestic subsidiary do not create a taxable event. However, once IPCo gained the ownership of the intellectual property, it could charge MSell a royalty for the use of that intellectual property. But here's the rub: For many years, states have amended their tax rules to disallow deductions for such royalties for the calculation of the corporate income subject to state tax. There were still a few states left that respected such royalties as a deductible expense. Put differently, *the only tax-planning tool that Jay deployed had almost become obsolete*. His average state tax has been creeping up.

1. The issue of the deferred taxation of income earned by controlled foreign corporations is a long, complicated matter covered in Treas. Reg. §1.954. This issue is not necessarily U.S.-specific, as almost all countries have anti-deferral rules for passive and certain other types of income earned by controlled foreign corporations.



would be. Jack struck a good balance between coming across as an open-minded and well-prepared executive, "I think we should all submit a couple of names, as we all know people who have a vision in retailing, and select those who do not have a conflict of interest and are willing to serve."

Just when the establishment of the Bluesky committee seemed like a foregone conclusion, CFO Amy Parker took the floor. "I think we are experiencing a serious disconnect here," she said, sending a chill through the room. "We are forgetting that this company owes its success to a no-frills, low-key product strategy. We worked hard and negotiated long to build this company under Karen Wu's vision. Why now do we need a 5-by-5 committee to forge our way forward?"

After a rather uncomfortable pause, and perhaps hoping someone else would respond, Jack scrambled, "Amy, we are not questioning Karen Wu's vision and skill in building this company. I for one do not have a feather in my cap for starting up a company and turning it into \$600 million juggernaut, with stores in 20 countries. She had a great vision and executed on it. In fact, it takes a committee of five to even try to match her brilliance. At this time, none of us, including Karen Wu, has a vision as to where to go from here. Hence the point drop in our stock price since the IPO. If we are to grow, and become \$1 billion, \$2 billion company, we will need to have a methodology for product and marketing innovation. If no one has the vision for it, we build it with a committee or whatever other means available to us."

Amy was not convinced, "I've never heard of a creative committee taking a company to those levels."

"Karen Wu will certainly be on it."

Snorting, Amy retorted, "So that you can all further frustrate her."

There was a crackle on the speaker. Karen Wu's voice filled the room as clearly and strongly as if she were there, "Amy, many thanks for your loyalty. I know that you meant everything you said, but, Jack is quite right; the reality of MSell is that we do not have our next big idea. To fulfill our ambitions, we need to work on the next big plan." She paused, waiting for Jack to speak, but continued on her own, "But Amy Parker is also right. A large committee may very well waste our time. Let's make it a three-person committee: You, me, and one more person from this Board." Sensing the approving head nods, she added, "I nominate Mr. B As a successful recycler of old, tired brands, he probably has the most experience to decide what kind of branding will work best for us." Mr. B was indeed a brand recycler, purchasing stale, old, or bankrupt consumer product brands, and breathing fresh life into them. Jack agreed to Karen Wu's suggestion.

If everyone was expecting a long committee process, they were surprised. Karen asked Mr. B if he could stay after the Board meeting and work through dinner. Mr. B cleared his schedule to oblige. Karen Wu also recruited Erik as a resource, to serve as secretary to the special committee. "We will resolve this issue before the day ends, meaning by midnight," she announced. She asked Erik to put together a list of the now defunct or

discontinued, or underused trademarks. "Considering our retro tendency and mostly male focus, we should have a strong, reliable, but generally agreeable brand image."

Here is a quick summary of the committee meeting: Karen Wu set the stage by stating that it would be preferable to recycle a brand rather than start from scratch. Jack suggested their current brand, "Why not modify it to two letters, say MS?" He quickly realized the unfortunate use of that two-letter acronym for the deadly disease Multiple Sclerosis. "Or something that stands for M and S? Perhaps use the Greek letters: Mu Sigma?" Karen Wu liked this idea. Mr. B suggested using only a single Greek letter, warning that two or more would sound like a fraternity. Searching the Internet, the small team did not like Mu, and Karen strongly favored Epsilon. Erik's research uncovered that while it had been used for some products in the past, there was currently nothing being sold under the Epsilon brand. "It sounds like Omega, but not Omega," Karen exclaimed. "I like it, it has a nice ring to it; sort of scientific, but fresher than Omega," said Jack. "There is a bit of softness in it, as well. I guess at some point you will start targeting women as well. I think Epsilon has a nice unisex appeal," added Mr. B and called up someone to do a deeper trademark research on registrations for Epsilon. They got a call back in half an hour: Federal registrations of the Epsilon mark were limited to somewhat unrelated products and services, but it may have been used with such a registration. Nor were there any indications of international usage or registrations. The committee meeting culminated within two hours, before dinner, and it was decided that Mr. B would recommend a law firm to perform the final search and filings. Erik interjected to suggest doing a few focus group studies and marketing experiments to gauge how others, meaning consumers, would react to the new brand, "I know introspection plays a big part in business, but we may not be very representative of our customer base." Karen Wu asked whether Jack could quickly and cheaply run a marketing analysis. "I do not want additional suggestions from them. They should just go out and find out how people react to Epsilon."

Once Jay learned that the meeting had concluded, he scheduled a call with both Bruce Balaban and Corrine Rogers, hoping to inquire about any potential tax implications of a new brand. Excited by this development, his advisors inquired about whom was leading the efforts, to which Jay replied, "Karen Wu, of course, as she is now the head of our China sourcing company, resident in China. And I'm sure that our new CEO in the U.S. and Erik, head of Europe, will also be involved."

Corrine laid out the basics for him, "You have a choice as to which one of your legal entities, existing or new, will be the beneficial owner of the brand rights, and for which territories. I would say that you need to combine two things, which are funding and control. Funding is flexible, and it seems you may have control in China, or the U.S., or perhaps the U.K." Bruce added, "You would need a good Subpart F analysis. In general, if a controlled foreign corporation owns an intangible used in the U.S., it may not be able to defer the income derived from that intangible."<sup>1</sup>

1. This is a highly technical area in which the definitions of where an intangible is used, whether it has a basis, and the character of the income derived from the intangible are fairly complex.



the ownership by geography, say, MSell-US owning the U.S. rights and MSell-EUHQ the European rights, or we can fracture by field of use."

"Whose use?"

"Say, the new Epsilon trademark. One potential field of use is as store name and the other one is as trademarks on our products."

"I never thought of this before. Where would they reside if we do nothing?"

"In the U.S. mostly, I suppose, as everything started here. But we also have our sourcing strategy from China and our sourcing related intangibles are owned there. We can also think about the UK Our European headquarters are there. So I will say that we have three choices: U.S., China, or the UK."

"Which would be best?"

"All else being equal, I would say China. Given our structure, we can have a fairly low tax rate in China."

"China? I thought the UK tax rate would become lower than the China rate. Also everyone talks about trapped cash in China. I certainly do not want that."

"Nor do we, although we have a good reverse hybrid structure that gives us a lower overall tax rate in China."

"Reverse what? You sure you are not talking about fuel efficient hybrid cars? Are we going to buy a fleet of hybrid cars and claim a tax credit in China?"

For the next couple of minutes, no one was able to speak, as they were all overcome by laughter. After several failed attempts, Jay was finally able to ask, through his laughter, "Anyway, your reverse hybrid, would that give us a good IP protection? I am sure our legal department will be all over you on this?"

"We can still rely on the U.S. legal protections. Put differently, it does not make it any better or worse for legal protection. We are really talking about beneficial ownership for tax purposes. All our trademarks will still be registered in the name of MSell Corporation."

"That is good to hear. So there is no reason why we should not do this then, correct?"

"It requires an upfront investment to set up the structure."

"But you said you have your reverse hybrid thingy already set up in China."

"Yes, but adding more intangibles would require more work, as well as valuations, tax planning, opinions."

"How quickly can we earn back our investment?"

"Depends on business success; if we decide to go to China and fund the entire trademark initiative out of MSell-PRC and that turns out to be a run-away success, I will say fairly quickly. If our trademark flops, perhaps, that might actually be never."

"Stay close to this initiative. It has just started and may yet fizzle away, but this is exciting stuff, wouldn't you agree, Erik?"

Erik nodded in agreement. Jack asked Jay to put together a proposal, "I just need a slide. How much would be the upfront investment, how fast can we recover it, and what are the risks? I would like to keep as much of our profits as possible but do not want to take huge tax risk either. I certainly do not want to be exposed on the front page of some national publication because of this." Erik commented that there was no such thing as bad publicity. They all laughed. Jack turned to Mr. B and they walked away.

Finally, Jay was able to ask more details from Erik about the Canadian audit. Through their interviews with Erik and others, the CRA (Canadian Revenue Agency) learned about MSell's wholesale business. They then requested wholesale price data for the 100 best selling items in Canada. When they recalculated Canadian gross margins using the U.S. wholesale prices, instead of the transfer prices, they ended up with approximately 15 percentage points of net sales higher operating profits. "Their logic seems impeccable to me," explained Erik, "after all had not we considered such an approach. I remember that I had brought that up. You and ABC Advisors had liked my idea, but decided to use the TMM benchmarking instead. I am afraid that may not have been the best way to go about transfer pricing." Although feeling furious, Jay opted for sarcasm, "Hope you were not the one advising CRA about the use of the wholesale prices in their audit."

"Of course not."

"Sorry, I am just kidding. Look, if I remember correctly, there were some significant differences between our retailers and the department stores. I believe we can explain away the 15 percentage points with those differences."

"Hope so."

"I am sorry, Erik, but you should have really kept me in the loop about this CRA audit. I am hearing things after the fact. That really is not the best way for me to ..."

"Sorry, Jay, but I remember mentioning the Canadian audit to you a while back. You did not inquire about it at all, or perhaps you may have sent an email or two asking for more details, but this is your area. You are the global tax director. When you did not show interest, what did you expect me to do?"

"Refer them to me. For God's sake, how difficult would it be to forward some correspondence and emails?"

"A lot more than you think. You know how we are chronically in start-up mode in this company, right? Do not expect your work to be presented to you in a platter. You should take the initiative."

"I am taking it now. Please send me all the correspondence from the CRA."



a European store to be used for a new U.S. store. Considering this possibility, it may be a reasonable strategy to err on the side of including more of the expenses in the global cost-sharing bucket, especially if there are already regular interactions and exchanges between the North American and European teams.

When Jay asked how to arrive at the cost-sharing percentages, he was introduced to the concept of "reasonably anticipated benefits." Bruce appeared to be quite opinionated about this topic, which Jay countered with a bit of skepticism. He had always believed that the best advisors were the ones that go about their work without passion or prejudice.

Bruce launched an intriguing tirade, "Reasonably anticipated benefits, or RAB shares, is a simple but often misunderstood concept. Its definition could not be simpler: If the parties are developing an intangible, they should bear the cost in proportion to how much they expect to benefit from it. But making it operational is a challenge. In practice, many of the cost sharing arrangements rely on relative net sales for the RAB shares."

"That is what I heard, as well. Do you have anything against it?"

"I believe that net sales may probably be the right choice in almost all cases, but the reasons for which people choose it are often the wrong reasons."

"Intriguing, so you believe most taxpayers select the correct measure for RAB shares, but for the wrong reasons?"

"Let me explain. The common reason provided for the choice of net sales is that the profitability will be the same globally and, given the lack of reliable data on future profit margins, the net sales would be the most reliable measure profits. If you just look through a sample of geographic segment data provided in 10-K submissions, which I did many times, you will quickly note that they are rarely the same. The U.S. market, with its enormous size, relative isolation, and different structure and regulations, differs significantly from that of Europe and the fast-growing Asian economies. I think it would be difficult to support such an assertion. In any case, even if it were true, when you think about it, the benefit from an intangible cannot be measured even at the usual operating profit level. You have to go further down and measure residual profits. Even then, you are still picking up the entrepreneurial risk components, which are not really attached to intangibles."

Cutting in, Jay asked, "And your point?"

"My point is that the benefit should really be the benefit to the intangible, and the intangible alone. What is the pure benefit from an intangible? It is the license royalty savings, the so-called relief from royalty. When you look at a large number of licensing agreements from a diverse set of industries, you can say the following things: First, they are almost always specified as a percentage of net or gross sales. Second, the majority of license agreements do not differentiate rates among territories, although quite a few do. In any case, I would say that the use of net sales would be a good measure because intangibles, on their own, earn returns specified as a percentage of sales."

"So it is allowable to use net sales then?"

"Yes, but that is not the end of the story. You must also ask net sales over which period of time? Splitting development costs by the current year net sales would be distortive in your case because your U.S. operations are fairly mature and will grow at 3 to 5 percent at best, while you will be ramping up much faster in Europe and elsewhere."

"What do we use then? Some sort of projections?"

"I would use the net present value of expected sales and do periodic updates as actuals and revised projections become available."

Their discussion fizzled as Jay lost his enthusiasm about cost sharing, given its complexity. Also, the strict non-overlapping territory rule would have required MSell to bring back to MSell-US the North American rights for vendor relationships (possibly) and product designs (for sure). All in all, Jay was thinking of cost sharing as a mere matter of intellectual curiosity, but he also wanted to take the opportunity to learn all of the angles on cost sharing for a hearty discussion with his friend Jeff.

"Let's wrap up on cost sharing then. As I see it, I have a more limited range of IP rights that I can retain at MSell-PRC and quite a few administrative headaches trying to get the RAB shares right, and watch out for the 10-year commensurate with income rule. I will have lower benefits and attract more scrutiny. It seems like an option I can easily eliminate. What do you think?"

"I agree with you. Given your facts, it is not attractive."

"Would it ever be attractive to any other taxpayer, say, to a diversified manufacturer?"

"In my mind, the ideal fact pattern for cost sharing would be between two related companies, each of which has relatively self-contained business operations within separate territories but exploiting common technologies."

This comment opened a pathway in Jay's memory to a past conversation with Jeff about their gas supply business, which operates an on-site supply model. Jeff had explained that their customers often require continuous supply of significant amounts of certain gases. In such cases, Diversified Industries would build their plant on the customer's premises to avoid transportation costs. Jeff had explained that they have a cost-sharing arrangement in place and it works pretty well because other than sharing the technology, each on-site plant is a self-sufficient business operation.

The advisor further expanded on this topic, "On the other hand, if you have a globally integrated supply chain, as you do, it is easier to sustain a global principal model with a single IP owner, supplying the entire world, as is fairly common in the pharmaceutical industry."

The meeting ended with Jay asking for time to think through the options and setting up a date for a presentation to management. When Jay later shared this discussion with Jeff, his old friend just became animated, "How could Bruce even think of cost sharing