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# ROYALTY RATE VALUATION IN TRANSFER PRICING: ANALYSIS FROM A TAX AVOIDANCE PERSPECTIVE

Undergraduate Thesis

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I hereby declare that I am the sole author
of this Bachelor Thesis and it has
not been presented to any other
university for examination.

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## Abbreviations

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| APA | Advanced Pricing Agreement |
| CFC | Controlled Foreign Companies |
| CMP | Comparable Profit Method |
| CUP | Comparable Uncontrolled Price Method |
| HAO | Administrative Court (Hallinto-Oikeus) |
| JTPF | Joint Transfer Pricing Forum |
| KHO | Supreme Administrative Court (Korkein Hallinto-Oikeus) |
| MNE | Multinational Entity |
| OECD | Organisation for Economic Co-operation and Development |
| PMS | Profit Split Method |
| VML | Act on Assessment Procedure, Finland (verotusmenettelylaki 1558/1995) |

## Introduction

An increasing number of companies are active in many countries. Globalisation has affected the business world and companies have the opportunity to make many strategic considerations. Some of these companies have established a global presence by spreading operations all over the world, while some have kept for example product development in the same country where their headquarters is located. In perfect competition conditions an equilibrium price between independent parties is obtained by the law of demand and supply, where no actor is willing to pay more for an asset than what is necessary. However, a group of companies has a common business interest and therefore transactions between them may consist of conditions that would not have been executed between totally independent parties.

Nowadays even 60% of global trade consists of these kinds of intra-group transactions and thus considerations about transfer pricing methods and taxation issues are truly economically important.[1] Tax avoidance and aggressive tax planning have recently been in the media spotlight. Often the line between tax planning and tax avoidance remains unclear and research between royalty rate valuation methods in transfer pricing transactions and legislative limits is thus important. International corporations might enter into covert distribution of profits for tax minimisation or tax avoidance purposes.[2] By transferring profits to a low-tax country or making a profit transfer within the corporation to an unprofitable company, an intra-group company may avoid taxes that it would have to pay without such transaction.[3] Tax can also be avoided by agreeing on more favourable prices, royalty rates and other contract conditions within the intra-company parties.[4]

Companies have used transfer pricing for transferring their profits to low-taxation countries and acquiring tax relief from such arrangements. Transfer pricing is regulated in international and national rules and all transfer pricing transactions must comply with the arm’s length principle. This principle demands that all transactions within the corporation must be priced in the same way they would have been between independent parties. Application of the arm’s length principle is especially difficult for transactions concerning intangibles and royalties, where

[1] Helminen, M. Kansainvälisen konsernin sisäiset palvelut verotuksessa, Jyväskylä, Kauppakaari Oyj 2000, p 5.
[2] Helminen, M., Kansainvälinen tuloverotus, Vantaa, WSOY 2005, p 156.
[3] *Ibid.*
[4] *Ibid.*

comparability between the assets is low and thus for example the OECD has released special considerations for intangibles in transfer pricing.

Companies have many methods to valuate their royalties within transactions and thus the aim of the research is to find out how royalty rates should be valuated in transfer pricing situations so they are not considered as tax avoidance according Article 28 of the Act on Assessment Procedure (1558/1995) in Finnish law. It focuses on the definition of tax avoidance, valuation of royalty rates and transfer pricing concepts, and explains the associated legislation in Finland. This thesis examines tax avoidance possibilities in royalty rate transfer pricing from the Finnish law point of view, but research and sources have prooved that regulations are not too deviant from each other in another EU member states.

The research aim is:
**How should royalty rates be valuated in transfer pricing so they are not considered as tax avoidance according to the Act on Assessment Procedure (1558/1995) in Finland?**

The research questions are:
- **How is transfer pricing regulated?**
- **What are the methods for defining the arm's length transfer price for royalties?**
- **What is the limit between tax planning and tax avoidance with regards to royalties in the transfer pricing process according to Finnish law?**

And the hypothesis for the research is:
**The size of royalty rates in transfer pricing that are considered as tax avoidance is unclear in the Act on Assessment Procedure (1558/1995) in Finland.**

The introduction introduces the reasoning behind the choice of the subject, research questions, hypothesis and the aim of the thesis. After the introduction, the thesis continues with the theoretical part and the first chapter concerns the concept of transfer pricing and associated legislation regarding it. It introduces valuation in transfer pricing on a general level and the most common valuation methods in adjusting transfer price. The concepts of ownership, licensing and royalties are discussed in the first chapter. The second chapter introduces the problem upon determination of the arm's length price for royalties in transfer pricing. It discusses the special requirements in intellectual property right transfer pricing in detail and explains the possibilities for companies for valuating their royalties within the process.

The third chapter focuses on Finnish legislation regarding the taxation of royalty payments and the limits for acceptable tax planning in Finland. Author discusses the difference of acceptable tax planning and tax avoidance and means for tax avoidance in the case of royalties. The aim of the chapter is to find out whether there is a specific limit for an acceptable size of royalty rates in Finnish legislation and how the VML should be interpreted. The chapter also examines the issue with the help of the Finnish Supreme Administrative Court and Administrative Court decisions. Case law attempts to find interpretative support for the research questions and the selected case law represents the most relevant cases applicable for royalty rate valuation methods. Due to the lack of fully comparable precedents, interpretation of the determination of the arm's length transfer price is made with the help of case law regarding other intra-group transactions. The conclusion combines the main findings of the research and suggests possible new topics for future research.

The research is based on qualitative research methodology. The thesis investigates the regulations of tax avoidance in Finnish law by interpreting the limits it sets for royalty rates in transfer pricing situations.. Books used in the research are mentioned in many legal articles and they concern European Union tax law, European Union law, Finnish tax law and intellectual property rights. The subject is also treated by appreciated Finnish literature regarding the specific field of study, for example publications from the Association of Finnish Lawyers and Marjaana Helminen and Matti Myrsky, who have focused on the topics close related to the thesis. The thesis includes interdisciplinary academic materials regarding transfer pricing and accounting. Articles are mainly acquired from HeinOnline and verified as peer-reviewed academic sources. In addition to these, OECD transfer pricing guidelines and materials from Finnish tax authorities formulate an important part of the thesis's sources. Amongst one of the experts referred in the thesis is Alder & Sound's Senior Associate Mr. Sampo Viding.

The thesis centralises the issues directly linked to the research question and excludes many interesting and closely related subjects within the same field on study. The author also deals with intellectual property rights as an entirety and does not separate for example patents, trademarks or copyrights from each other, even though there are some differences in for example valuation processes. The author focuses on the most suitable valuation methods specifically regarding royalty rates and does not include an exhaustive list of methods or mathematical formulas. By the term tax avoidance, author refers illegal action prohibited by the law.

# 1. The Concept of Transfer Pricing

Transfer pricing designates the price given for all business transactions between the associated companies within the same corporate group.[5] An association exists when companies have direct or indirect significant power over each other within intra-group transactions.[6] Transfer pricing transactions consist of the trade of goods and services, as well as for example the payments from the use or total transfer of intellectual property rights.[7] The arm's length principle gives the basis for all transfer pricing transactions. According to this principle, associated companies must transfer the price all of their transactions with the same principles as they would price transactions between independent parties.[8]

The growth of multinational entities (MNEs) can set challenges in transfer pricing and international taxation, when companies are under subject to different legislation and administrative requirements.[9] In Finland and in another OECD member states, transfer pricing follows the OECD's transfer pricing guidelines.[10] The guidelines regulate how transfer pricing should be taken into account on assessment procedures in member states' own legislation and how the arm's length principle should be adapted.[11] The purpose of transfer pricing regulations is to distribute income between the states and minimise conflicts between taxpayers and tax administrations. OECD member states have adapted guidelines for securing an appropriate taxation base and avoiding double taxation.[12]

## 1.1. Legislative Basis for Transfer Pricing

International tax laws apply in cross-border situations where the source of income is in a different state than where the income recipient resides or when the location of property differs from the location of the property owner. Unilateral domestic tax law, bilateral or multilateral tax treaties and European Community tax law together constitute Finnish international tax law.[13] The rules under these three different legal systems determine how certain tax objects are taxed in

[5] Terra, B. *et al.* European Tax Law, Boston, Kluwer law and taxation publishers, 1993, p 207..
[6] Suomen verohallinto, siirtohinnoittelu, www.vero.fi/fi-FI/Yritys_ja_yhteisoasiakkaat/Siirtohinnoittelu (15.3.2017).
[7] *Ibid.*
[8] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, p 17-19.
[9] Helminen (2005), *supra* nota 2, p 165.
[10] Suomen verohallinto, siirtohinnoittelu, *supra* nota 6.
[11] OECD Transfer Pricing guidelines (2010), *supra* nota 8, p 18.
[12] *Ibid*.
[13] Helminen, M. Finnish international taxation, Vantaa, WSOY 2002, p 2.

international occasions. Unlike European Community law, international tax law does not provide supranational rules for member states. In Finland, the state independently adjusts the tax laws relating to its international relations. International regulations for transfer pricing become applicable when income is derived from intra-group transactions between associated companies and companies are liable for taxation under different states.[14]

The European Union was established in the Maastricht Convention in 1993.[15] The Union is structured from three Pillars, which are European Communities (EC), Common Foreign and Security Policy (CFSP) and Police and Judicial Co-operation in Criminal Matters (PJCCM). EC Norms affecting taxation issues within the European Union are called EC tax law. EC tax law norms limit Finnish taxation rights in cases where the tax objective or tax subjective is related to Finland and some other EU country.[16] European Union laws and thus EC tax laws are a supranational jurisdiction for EU member states. However, each EU member state has retained broad sovereignty over deciding their direct national tax regulations.[17] Sovereignty is limited by the principle of subsidiary, which becomes applicable in situations where the EC must intervene in direct taxation to ensure the internal market's functionality. EC law mainly focuses on indirect taxation issues and ensures that cases are solved as close to their destinations as possible.[18] It becomes applicable in cases that can't be dealt with within the member state. The aim of EC tax law is to ensure a common legislative basis for member states, ensure functionality of internal markets and give regulations to avoid double taxation.[19]

### 1.1.1. The EU Arbitration Convention

The concept of transfer pricing is regulated in the 90/436/EEC convention on elimination of double taxation in connection with the adjustment of transfers of profits between associated undertakings (EU Arbitration Convention).[20] The convention emphasises two important rulings with regards to transfer pricing: article 4 on the arm's length principle and article 12 on the obligation to eliminate double taxation. The arbitration convention promotes the elimination of double taxation between associated companies with the special adjustment of transfers of profits.

[14] Helminen (2002), *supra* nota 13, p 1.
[15] Helminen (2005), *supra* nota 2, p 26-27.
[16] *Ibid.*
[17] Terra, B. *et al.* (1993), *supra* nota 5, p 2.
[18] Helminen (2005), *supra* nota 2, p 26-27.
[19] Helminen (2002), *supra* nota 13, p 3.
[20] Terra, B. *et al*. (1993), *supra* nota 5, p 207.

It regulates the reciprocal relationship between the contracting states and gives competence to the relevant tax authorities. A taxpayer living in for example Finland is also obliged to pay taxes from the incomes derived from abroad to Finland. Often the same income is already taxed abroad on the basis that the income is obtained there. Double taxation shall be eliminated in these cases either by the exemption method or credit method regulated within the convention.
The convention also enables use of an advisory commission and improves cross-border conditions within the EU internal market.[21]

### 1.1.2. The Parent-Subsidiary Directive

The directive concerning taxation between parent companies and their subsidiaries located in different member states within the EU was originally established on July 1990 (90/435/EC).
The directive has been amended multiple times and the latest consolidated version (2011/96/EC)[22] aims to improve taxation within MNEs by removing double taxation in withholding taxes on payments of dividends between the parent company and its subsidiaries.[23] The directive has been adopted by all EU member states and it is applicable for transactions within the EU. From the Finnish company forms, limited liability companies, cooperatives, savings banks and insurance companies are covered by the directive. According to the directive, a parent company is an EU-based company that has an at least 10% share from its subsidiary located in another EU member state.

The directive regulates that profits that a subsidiary distributes to its parent company shall be exempt from withholding tax and the state of the parent company may not withhold tax on the profits received through subsidiary-parent distribution.[24] The subsidiary can also distribute profits for a parent company or a permanent establishment after the actual realisation period. Taxation in these cases is arranged so a member state, where either a parent company or permanent establishment is located, either does not tax the income at all or allows the subsidiary to deduct the payable tax. The parent company or a permanent establishment must tax shared profits insofar as profits are deductible to the subsidiary in order to prevent companies from planning the intra-group company payments in a way that they could benefit from the deduction

[21] Helminen (2002), *supra* nota 13, p 236.
[22] Council Directive 2011/96/EU of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States.
[23] Terra, B. *et al.* European tax law, Boston, Kluwer law international 2008, (5) p 457.
[24] Terra, B. *et al.* European tax law, Boston, Kluwer law international 2005 (4) p 493.

of double taxation. However, an EU member state may adjust it so the related expenses or the depreciation from the subsidiary's profit sharing may not be reduced from the parent company's taxable incomes.

### 1.1.3. Model Tax Convention Article 9

With specific tax agreements, states may allocate their taxation rights in international situations and prevent double taxation and tax avoidance.[25] Tax agreements are usually drafted from the basis of the OECD model tax convention and implemented to the member states' national legislation.[26] The model tax convention formulates the basis of bilateral tax treaties between OECD member states and between OECD member states and non-member states. Bilateral treaties include grievances arising from international tax principles. The principles are compounded with the Model United Nations double taxation convention between developed and developing nations.[27] The most important tax article in the model tax convention regarding transfer pricing issues is article 9 on associated enterprises. The arm's length principle is regulated in the OECD model tax convention's article 9 as:

"(Where) conditions are made or imposed between the two associated enterprises in their commercial or financial relations that differ from those that would be made between independent enterprises, then any profits that would, except for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not accrued, may be included in the profits of that enterprise and taxed accordingly."

The arm's length principle is an internationally recognised transfer pricing standard, which all OECD member states and an increasing number of non-member states have agreed to use as a guideline for tax purposes in MNEs and in tax administrations.[28] It seeks a certain level of income within a transaction between related parties, which is in accordance with the result that would have been achieved between independent parties.[29] The principle provides coordinated tax treatment for MNEs and independent parties and it promotes equal competition for all parties by

[25] Helminen (2005), *supra* nota 2, p 20-22.
[26] OECD Transfer Pricing guidelines (2010), *supra* nota 8, p 18.
[27] *Ibid.*
[28] OECD Transfer Pricing guidelines (2010), *supra* nota 8, p 31-32.
[29] Terra, B. *et al.* (2005), *supra* nota, p 578.

removing economic considerations from tax-related transfers.[30] OECD member states have agreed to contribute the proper implication of the arm's length principle and correct any possible distortions with the help of adjustments.[31] According to the Article 9, two enterprises are considered associated with each other if both enterprises and the persons within it are indirectly or directly under the same management, control or capital in different contracting states

MNEs are served in similar to separate entities and observations are targeted at the nature and conditions of transactions.[32] The arm's length principle relies on supposition of the effectiveness of the markets to create the prices itself and the aim of the arm's length principle is to ensure that tax and incomes are paid in the right country.[33] The principle is highly appreciated for comparable and independent transactions within the markets and it applies to transactions between companies within the same corporate group as well as between the transactions of a company and its permanent establishment.[34].

### 1.1.4. OECD Transfer Pricing Guidelines and Joint Transfer Pricing Forum

OECD Transfer pricing guidelines are created for tax authorities and MNEs to find a common solution between these entities in transfer pricing situations. The guidelines emphasise the consideration of international issues in transfer pricing and the application of the arm's length principle in positioning the price for transactions within a corporate group.[35] In detail this means valuation, tax considerations and clarification of intention in cross-border transactions.[36]

Guidelines are not a legally binding source for transfer pricing within states, but they are still widely applied. Transfer pricing guidelines were originally published in 1979 for multinational entities and tax administrations.[37] The current version was released in 2010, which notices the importance of case-by-case consideration in finding the most appropriate transfer pricing method.[38] In October 2015, the OECD released final reports on its action plan on base erosion and profit shifting (BEPS). The report focuses on the prevention of certain business strategies,

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30 OECD Transfer Pricing guidelines (2010), *supra* nota 8, p 34.
31 OECD Transfer Pricing guidelines (2010), *supra* nota 8, p 32
32 OECD Transfer Pricing guidelines (2010), *supra* nota 8, p 34.
33 Helminen (2002), *supra* nota 13, p 139.
34 *Ibid*.
35 OECD Transfer Pricing guidelines (2010), *supra* nota 8, p 19.
36 OECD Transfer Pricing guidelines (2010), *Supra* nota 8, p 19.
37 *Ibid*.
38 *Ibid*.

which might result in tax avoidance through artificial profit shifts to low or zero-tax locations.[39] According to the OECD, more than 100 countries are implementing the methods into their jurisdictions.[40] In 2002 the European Commission established the EU Joint Transfer Pricing Foru to give non-legally binding assistance on tax matters regarding transfer pricing-related issues. The JTPF consists of a group of experts working within the framework of the OECD transfer pricing guidelines. [41]

### 1.1.5. Finnish Transfer Pricing legislation

Regulations regarding tax avoidance, transfer pricing adjustments and documentation are included in Finland's national legislation *Laki verotusmenettelystä (VML)* 18.12.1995/1558. Later discussed ruling on tax avoidance is regulated in Article 28 of VML. A tax increase provision *Veronkorotussäännös* 32 §4 and provision on transfer pricing adjustments *Siirtohinnoitteluoikaisu* 31§ are included in the VML. Finnish tax authorities set new rulings for transfer pricing documentation in 2007. According to the Finnish tax administration, the arm's length principle should be implemented in accordance with the OECD's transfer pricing guidelines. The OECD's transfer pricing guidelines are implied in VML §31 and the supreme Administrative Court (KHO) has also referred to the importance of interpretation the OECD's model tax convention in its decisions KHO: 2013:36, KHO: 2014:33 and KHO: 2014:119.[42]

According to the VML §31, transactions between a permanent establishment and an establishment in another country should be accounted in accordance with the arm's length principle. If a taxpayer and a party related to it are executing transactions diverging from the principle, the parties are obliged to compensate the differential to correspond to a payment that would have been made between independent parties.[43] Associated companies are defined as a non-independent, non-arm's length relationship between a taxpayer and the company.[44] An

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[39] OECD, About BEPS and the inclusive framework, www.oecd.org/tax/beps-about.htm (15.3.2017).
[40] *Ibid.*
[41] European Commission, Joint transfer pricing forum, www.ec.europa.eu/taxation_customs/business/company-tax/transfer-pricing-eu-context/joint-transfer-pricing-forum_en (15.3.2017).
[42] Suomen Verohallinto, kannanotto A177/200/2015, OECD:n siirtohinnoitteluohjeiden päivitykset tulkintalähteinä, www.vero.fi/fi-FI/Syventavat_veroohjeet/Elinkeinoverotus/Kansainvalinen_verotus/OECDn_siirtohinnoitteluohjeiden_paivityk(39302) (15.3.2017).
[43] Finnish Tax Administration, Income taxation of foreign corporate entities, www.vero.fi/en-US/Precise_information/International_tax_situations/Income_taxation_of_foreign_corporate_ent(26122) (15.3.2017).
[44] *Ibid.*

associative relationship exists if the taxpayer company has an ownership of interest exceeding 50% of either the shares and votes of another enterprise or has a direct or indirect right to nominate more than half of the board of directors from another enterprise, or in some other circumstances has a powerful position in respect of the other enterprise.[45] If the association exists, transactions between a foreign company and its permanent establishment in Finland are required.[46] Transfer pricing documentation verifies successful application of the arm's length principle in a company's pricing. The transfer pricing guideline sets out the requirement for documentation from the transactions between associated companies. In Finland, the national legislation's VML includes rules governing transfer pricing documentation requirements in §14a-c. According to this act, a taxpayer is obliged to prepare, submit and complement the documentation regarding transfer pricing.

### 1.2. Valuation in Transfer Pricing

Transfer pricing methods vary according to the context in which it is applied. Companies retain the freedom to apply their own methods to establish a transfer price, but the other obligations regarding transfer pricing must still apply; according to the law, a company must for example provide documentation regarding the transfer pricing for tax surveillance purposes.

There are many methods to adjust the arm's length transfer price. Practical qualification of the price is often difficult because multinational companies are under different jurisdictions and the operations, incomes and expenses are highly integrated.[47] A transfer pricing method should always be selected in accordance with the appropriateness for certain transactions.[48] The selection process must include evaluation of the appropriateness of the method with regards to a specific nature of the transaction, level of comparability, standard of knowledge and consideration of the possible adjustments.[49] Methods can be shared in traditional transaction methods and transactional profit methods. A traditional transaction method consists of a comparable uncontrolled price method (CUP), the resale price method and the cost plus

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[45] Finnish Tax Administration (2015), *supra* nota 43.
[46] Finnish Tax Administration, Memorandum 1471/37/2007, Transfer pricing documentation requirements, www.vero.fi/download/Transfer_Pricing_documentation_requirements/%7B4AB2E68C-1098-4AF8-9689-C179FFE417BE%7D/6377 (15.3.2017).
[47] Helminen (2005), *supra* nota 2, p 168.
[48] Helminen (2005), *supra* nota 2, p 163.
[49] OECD Transfer Pricing guidelines (2010), *supra* nota 8, p 59.

method.[50] These methods are used to consider whether associated parties are arm's length in commercial and financial relations.[51] The transactional net margin method and the transactional profit split method are categorised under the transactional profit methods and they are more appropriate in situations where transactions are more valuable and unique or the functions are more integrated among each other.[52]

The benefit for intellectual property rights in general is most commonly valuated with income, market or cost approaches, which either measures the value that asset generates in the future, compares the existing market prices or estimates the costs of a comparable object.[53] The income approach valuates the intellectual property asset on the basis of returns, which it is expected to generate for the asset holder in the future and it includes a consideration of the time value of money and the ultimate valuation is made by financial models.[54] The income approach is widely used for intellectual property valuations, especially for patent valuation, and profit is obtained when the expected income is discounted to the present moment by discounted cash flow methods or net present value methods with the help of a specific discount rate.[55] The approach defines an asset's value on the market price basis and leans on objective markets and identical or similar transactions.[56] Intangibles' valuation fluctuates in accordance with the asset's activity in competitive and extensive markets and it calculates the benefits that the asset brings to the participant.[57] This approach emphasises the principle of substitution, which states that a buyer selects a comparable substitute over a more expensive asset. In addition to the substitute asset, transactions in the market approach involve active markets where price and terms are determined in advance.[58] The market approach is applicable if parties to a transaction act according to the arm's length principle and transactions are made simultaneously with virtual transactions.[59] In competitive markets the law of supply and demand designates the market price, and according to

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[50] OECD Transfer Pricing guidelines (2010), *supra* nota 8, p 58-59.
[51] *Ibid.*
[52] OECD Transfer Pricing guidelines (2010), *supra* nota 8, p 59.
[53] Goddar, H. *et al*., Patent valuation methods, The Economic Valuation of Patents – Methods and Applications, United Kingdom, Edward Elgar Publishing Limited 2011, pp 109-139, p 109-110.
[54] Dorit, S. Intellectual property valuation: A finance perspective, Albany Law Review, 2007 (70) 4 , pp 1207-1225 p 1213-1214.
[55] Goddar, H. *et al*., *supra* nota 53, p 110-114.
[56] Brauner, Y. Value in the eye of the beholder: the valuation of intangibles for transfer Pricing purposes, 2008, Virginia Tax Review, 28(1), pp 79-163 p 105-106.
[57] Goddar, H. *et al., supra* nota 53, p. 111.
[58] Smith *et al*. Intellectual property: Valuation, exploitation and infringement.
damages, Hoboken, John Wiley & Sons, INC, 2005, p 148-149.
[59] Smith *et al*. *Supra* nota 58, p 169, pp 148-149.

the market approach, the price of an asset traded on active markets is the most reliable way of valuating it.[60]

The third general valuation method is the cost approach. The approach measures the appraisal value of intellectual property by calculating the costs of replacing the intangible asset.[61] The cost approach does not have any financial model behind it and so it is entirely market driven.[62] It works on a replacement cost premise, where the markets become the valuator.[63] As intangibles are not usually manufactured and offered for market exchange purposes and there are no market prices to compare, the evaluation under the cost approach starts by estimating the cost of creating an intellectual property asset.[64] Within the cost approach, value determination can be done by using either the cost of reproduction new or the cost of replacement or by the historical method.[65] All methods include extensive calculation of costs, including for example hard and soft costs, profits and entrepreneurial incentives.[66] The cost of reproduction new (CRN) is derived from an exact replica of an intangible asset, meanwhile recreation of the subject asset's functionality or utility is the cost of replacement (COR) method.[67] The historical method turns historical costs into the existing currency by application of a price index and indicates the total amount that is needed to invest for the purposes of reproducing the property.[68]

The cost approach does not conceive some important driving factors in intangibles' valuation process and so it can't be considered as comprehensive as the market and income approaches.[69] Creating costs are not always a straight indication of the asset's value, and also negative effects into assets utility from obsolescence are excluded from the intangible's costs, and so depreciation and diminution must be considered separately in the cost approach process.[70] There are also hybrid approaches, which combine two valuation methods; the market and income approaches.[71] The arm's length principle does not require the use of multiple methods, but in

[60] Brauner, Y., *supra* nota 56, p 105-106.
[61] Dorit, S., *supra* nota 54, p 1213-1214.
[62] *Ibid.*
[63] *Ibid.*
[64] Smith, G.V. *et al*., *supra* nota 58, p 156.
[65] Reilly, R., Valuation of intangible assets in Dot.Com and intellectual property intensive companies, 2002. American Journal of Family Law, 2002 /15(1), pp 1-24 p 43.
[66] *Ibid.*
[67] Smith, G.V. *et al*., *supra* nota 58, p 159.
[68] Smith, G.V. *et al*., *supra* nota 58, p 160.
[69] Smith, G.V. *et al*., *supra* nota 58, p 156.
[70] Reilly, R., *supra* nota 65, p 43.
[71] Goddar, H. *et al., supra* nota 53, p 110-111.

situations where no approach is conclusive application of the various methods can be desirable for the best estimation of the arm's length price. [72]

Significant parts of the value of international companies' transactions are derived from intellectual property rights transfers.[73] Intellectual property refers to a company's nonphysical and nonmonetary property, for example patents, trademarks, copyrights, trade secrets and know-how. In a broad sense a company's intellectual property includes everything that the other party would be ready to pay for and thereby it includes assets also derived for example from the company's research and development activities, manufacturing operations and sales and marketing activities.[74] However, it should be noted that a transaction must truly create essential and verifiable value to be recordable as a company's intellectual property.

### 1.3. Ownership and the Release of the Related Rights

Intellectual property rights can be exploited in many ways and the owner has the full legal right to determine the operational functions over its intellectual property.[75] Transactions regarding intellectual property rights can consist either of alienation of the full right or the alienation of utilisation of the right.[76] Income derived from the use of intellectual property belongs to the property's owner.[77] The owner of tangible assets is unequivocally detectable while the verification of the owner of intangible assets is more difficult. Under the transfer pricing rules, the owner of an intangible is the person receiving allocated profits from the transfer of a property and if the owner cannot be directly identified, the determination is made based on the actual control over the intangible.[78] However, the matter is not so simple since multiple beneficiaries can enjoy the economic benefits derived from intellectual property.[79]

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[72] OECD Transfer Pricing guidelines (2010), *supra* nota 8, p 62.
[73] Abdallah, W.M. *et al*., Transfer pricing strategies of intangible assets, E-commerce and international taxation of multinationals. International tax journal, CCH Wolters Kluwer business, 2006, 32 (2), pp 5-46 p 1-11.
[74] Smith, G.V. *et al*., *supra* nota 58, p 126
[75] Smith, G.V. *et al*., *supra* nota 58, p 325.
[76] Visconti, R.M., Exclusive patents and trademarks and subsequent uneasy transaction. comparability: some transfer pricing implications, the Netherlands, Intertax, Kluwer law international BV 2012 40(3), pp 212-219, p 212
[77] Suomen verohallinto, Aineettoman omaisuuden siirtohinnoittelu, www.vero.fi/fi-FI/Yritys_ja_yhteisoasiakkaat/Siirtohinnoittelu/Aineettoman_omaisuuden_siirtohinnoittelu (15.3.2017)
[78] Brauner, Y., *supra* nota 56, p 125-126.
[79] *Ibid*.

In the case of alienation of the full right, the owner gives up all the rights and incoming profits regarding the intangible asset and it often contains some other property.[80] Licensing applies in cases where a company's purpose is to maintain the ownership of the right but the other party has been licensed to use the right as well. In licensing, a corporate group awards its subsidiary or subsidiaries the right to use the intellectual property rights for compensation, in other words royalties.[81] A comprehensive understanding of the terms and conditions enables the evaluation of licensing condition neutrality and it can be noted whether the license is granted on terms that the independent parties would have agreed on.[82]

### 1.3.1. Royalties

As discussed previously, a royalty is a payment made from the use or the right to use the qualifying intellectual property rights to its owner. Property may be used in more than one state and the owner of intellectual property may receive royalties from other states.[83] Payment of royalties may be made in money or in kind and the consideration may include one monthly payment or it can also be paid annually for example according to the annual turnover. The general definition for a reasonable royalty rate is that it is the amount that a licensee is willing to pay the licensor from the use of a patented invention while still gaining a reasonable profit from it.[84] OECD model tax convention article 12 defines the term royalties as:

"Payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trademark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience."

As there is no internationally accepted limit for the term of royalty, different states may have different definitions of the term and it may cause a classification conflict and international double taxation.[85] Finnish domestic tax law defines the term of royalty in *Laki rajoitetusti verovelvollisen tulon verottamisesta 1978/627 §3(3)* as for the use of or the right to use a

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[80] Suomen verohallinto, Aineettoman omaisuuden siirtohinnoittelu, *supra* nota 77.
[81] *Ibid.*
[82] *Ibid.*
[83] Helminen (2002), *supra* nota 13, p 217.
[84] Choi, W., Weinstein, R., An analytical solution to reasonable royalty rate calculations. IDEA the Journal of Law and Technology. Vol. 41, issue 1 (2000), pp 1-16, p 7
[85] Helminen (2002), *supra* nota 13, p 217-220.

copyright of literary, artistic or scientific work or a right on a photograph. It also includes a consideration for the use of or the right to use a patent, trademark, model, matrix, design, plan, a secret formula or process and covers the consideration of know-how arising from industrial, commercial or scientific experience.

## 2. Royalty rate Valuation in Transfer Pricing Process

Intellectual property transactions are often challenging to valuate for tax purposes. In order to understand the economics involved in intangibles' transactions it is important to understand their unique characteristics. Intangibles' transfer price is determined through the arm's length principle and it varies according to the context to which it is applied. There are some important general aspects that should be considered in intellectual property right transfer pricing.

One of the key elements of intellectual property rights analysis is their legal protection, whereas the law protects the owner of intellectual property from the unauthorised utilisation of it by others.[86] In international transactions the scope of protection provided in intellectual property legislation may vary between different countries.[87] The value of intangibles and thereby the value of the company's other assets are affected by the duration and coverage of legal protection.[88] The value of an asset is derived from profits that it brings to the owner.[89]

It is important to identify whether the intellectual property right really generates such a value from which some other independent party would be ready to compensate. In principle, income derived from the use of intellectual property rights belongs to its owner.[90] However, there can be some other parties that have participated in the intangible's development process and so are entitled to arm's length compensation for their taken risks and inputs.[91]

Companies define the price between intra-group transactions by themselves. In order to ensure equal market conditions and fair taxation to all actors, a price is ascertained through the arm's length principle.[92] The principle is based on the idea that a transfer price is established on a market value basis between companies within the same corporate group. The acquired arm's length remuneration should be the same as it would be between independent parties and thus determination of intangibles' transferring requires consideration of comparability and functional analysis, which measures the difference between these uncontrolled and controlled transactions.[93] The other important element of an intangible is its portability, since assets are often easy and cost-effective to transfer from one country to another. Intellectual properties

[86] Smith, G.V. *et al.*, *supra* nota 58, p 22.
[87] Brauner, Y., *supra* nota 56, p 87-88.
[88] *Ibid.*
[89] Goddar, H. *et al.,* (2011), *supra* nota 53, p. 109-110.
[90] Suomen verohallinto, Aineettoman omaisuuden siirtohinnoittelu, *Supra* nota 77
[91] *Ibid.*
[92] Terra, B. *et al.*, (2008), *supra* nota 23, p 563-564.
[93] OECD Transfer Pricing guidelines (2010), *supra* nota 8, p 33.

create and increase the value of the other assets within the company because they are in direct or indirect interaction with the company's tangible and financial assets.[94] Some parts of intangibles can be valuable for one company but may not be practically separated or transferable to another company and thus are again difficult to valuate.[95] Because of this, it is important to separate a company's intellectual property rights from other tangible assets for the purpose of valuation. [96]

It is essential to understand the broad view of the business type and all activities regarding it when analysing a company's transfer prices, and the actual contractual terms and conditions between the parties also influence analyses.[97] The value of a business enterprise and the value of intellectual property are also influenced by the industry in which the property is used and it also fluctuates according to market share, profits, new technologies, entry barriers, growth prognosis, legal protection and remaining economic life.[98] When applying the arm's length principle for royalties, the object, terms and conditions of licensing, and the licensee's business actions, resources and risks are to be analysed. Determination also requires analysis of the nature of controlled transactions and information regarding the use or transfer of intangibles.[99] Without this analysis, the suitability and reliability of transfer pricing methods comparability to royalties cannot be analysed with the required precision.[100]

The arm's length principle relies on supposition of the effectiveness of the markets in creating the prices itself and the aim of the arm's length principle is to ensure that the tax and incomes are paid in the right country.[101] The principle is highly appreciated for comparable and independent transactions within the markets and it applies to transactions between the companies within the same corporate group as well as between the transactions of a company and its permanent establishment.[102] The principle provides coordinated tax treatment for MNEs and independent parties. It promotes equal competition for all parties by removing economic considerations from

[94] Brauner, Y., *supra* nota 56, p 88.
[95] *Ibid.*
[96] Deak, D., Taxation of Intangible assets in Hungary, Hungary, The Intertax 31(12), Kluwer Law International, 2003, pp 506-522 p 512.
[97] Suomen verohallinto, Aineettoman omaisuuden siirtohinnoittelu, *supra* nota 77.
[98] Smith, G.V. *et al*., *supra* nota 58, p 173.
[99] OECD, Discussion draft Revision of the special considerations for intangibles in chapter of the OECD transfer pricing guidelines and related provisions, 2012, pp 1-60, p 6. http://www.oecd.org/ctp/transfer-pricing/50526258.pdf (15.3.2017)
[100] Suomen verohallinto, Aineettoman omaisuuden siirtohinnoittelu, *supra* nota 77.
[101] Helminen (2002), *supra* nota 13, p 139.
[102] *Ibid.*

tax-related transfers.[103] OECD member states have agreed to contribute to the proper implication of the arm's length principle and correct any possible distortions with the help of adjustments.[104] When transfer pricing is not done in accordance with the arm's length principle, tax liabilities and therefore tax revenues can be distorted.[105] When applying the arm's length principle for royalties, the object, terms and conditions of licensing, as well as the licensee's business actions, resources and risks are to be analysed. Without this analysis, the suitability and reliability of transfer pricing methods comparability to royalties cannot be analysed with the required precision.[106]

### 2.1. Determining an Acceptable Royalty Rate in Transfer Pricing

Configuration of an arm's length royalty rate in the transfer pricing process is ambiguous and challenging because it is influenced by so many things. As discussed before, the starting point for charging royalties and valuating its size is that a person or legal entity has ownership or disposition over the intellectual property right. Whereas the economic and legal right to use intangible rights is proven, royalty valuation continues with finding a comparable transaction.

On a practical level, finding comparable transaction and intangible assets is extremely essential in royalty valuation process. Comparable elements can be found from different kinds of contacts database, such as Royalty Stat.[107] However, the comparability of an asset is a complicated issue especially in royalty valuation and often a completely comparable asset does not exist. In principle the quality of a comparative asset is in any case tenuous and the success of valuation also depends on what the intellectual property right from where the royalties are charged is. For example patents are extremely unique and their valuation is frequently challenging with the comparability analysis.[108] If intellectual property rights have been licensed to a third party earlier, that value would be a good basis for the comparability analysis. However, these kinds of situations are rare and in most cases the comparability analysis is done with the help of other comparable contracts databases.

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[103] OECD Transfer Pricing guidelines (2010), *supra* nota 8, p 34.
[104] OECD Transfer Pricing guidelines (2010), *supra* nota 8, p 32.
[105] *Ibid.*
[106] Suomen verohallinto, Aineettoman omaisuuden siirtohinnoittelu, *supra* nota 77.
[107] Viding, S., Alder & Sound, Expert Opinion 13.4.2017 Helsinki
[108] *Ibid.*

Functional and comparative analyses are vital for royalty rate valuation in transfer pricing. Functional analysis focuses on functions, used assets and risks, comparability analysis, reviews ownership, contributions of members, identifications of intangibles and their characters and the nature of transaction.[109] Uncertainties like incoming future profits, issues regarding geographical area and export restrictions, the special character of the intangible transferred, investments, developments and for example distribution channels might affect the comparability and determination of royalties' arm's length prices. [110]

The transfer pricing method should be selected according to the contemplated asset and the principle of the best method rule.[111] In addition to market, income and cost approaches, there are some classic transfer pricing methods particularly for royalty rates and the most suitable method can be found after the comparison of a model's strengths and weaknesses. Comparison of the price is a basis for arm's length applications, and is most commonly made by calculating the margin or profits from similar transactions between independent undertakings or by the margin or profits from particular controlled transactions with the price.[112] The most recognised methods for royalty rate transfer pricing consist of the relief from royalty method, comparable uncontrolled transaction method, comparable profit method and profit split method. The traditional basis for the use of such mathematical methods is derived from the classic 25% rule.

### 2.1.1 The 25% Rule

In 1971 Robert Goldscheider introduced the 25% rule. The rule is a tool for companies to define a moderate amount of royalties in licensing situations and after its original use for patent valuation it has also been applied for other intellectual property rights: copyrights, trademarks, trade secrets and know-how contexts.[113]

The classic 25% rule is based on the income approach and the theory of rule of thumb and it underlies the idea that the licensor and licensee should share the profit gain from the licensed

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[109] OECD, Guidance on Transfer Pricing Aspects of Intangibles, 2014, pp 1-134 p 28. http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/guidance-on-transfer-pricing-aspects-of-intangibles_9789264219212-en#page30
[110] Smith, G.V. *et al.*, *supra* nota 58, p 384.
[111] Ruchelman, S., United states penalties in international tax planning, Campbell, D. (ed.), International tax planning, Kluwer law international, The Netherlands 1995, pp 1-350 p 326-327.
[112] OECD, Guidance on Transfer Pricing Aspects of Intangibles (2014), *supra* nota 109, p 28.
[113] Smith, G.V. *et al.*, *supra* nota 58, p 410.

intellectual property.[114] The main difference between the rule of thumb and the classic 25% rule arises from the way the rules consider the certain conditions affecting the division of revenues.[115] Even though both of the rules have the intent of correcting infringement damages by dividing revenues, the classic 25% rule defines a tentative dividing ratio according to the previous experience in each case separately, and it also takes into account the flexibility of the conditions affecting the parties and market conditions.[116] According to the 25% rule, the licensee is automatically entitled to 75% of the profit because of the great risk and further developments of what it has done to the product, while the licensor receives the remaining 25%.[117] Expected profits are divided by the expected net sales for the period in question in order to acquire a profit rate and the resulted profit rate is then multiplied to conclude a resulting royalty rate, whereby if a profit rate is 16% and it is multiplied by 25% it results in a royalty rate of 4 percent.[118]

The classic rule of 25% focuses on the licensee's profits, expected profits, long-run profits and fully loaded profits and the factors of the user and the usage purpose of intellectual property, the licensee itself and the organisational infrastructure in total have a great impact on its value.[119] The rule also focuses on expected profits and so forthcoming and on going use of intellectual property are also discussed in licensing negotiations because the projected benefits construct the licensee's access fee.[120] It usually takes time for a new company or invention to find its place on markets and start giving returns to the licensee and so intellectual property investments are done for long-run profit expectations. Short-term analysis of the value can give a narrow and unrealistic view of the upcoming profits and thus the classic rule of 25% focuses on the long-run profits in valuation and the economic benefit of the property is realised over the entire economic life of the product. [121]

[114] Smith, G.V. *et al.*, *supra* nota 58, p 410-414.
[115] Goldscheider, R., The classic 25% rule and the art of intellectual property licensing, Duke University School of Law Publications, 2011(6), pp 1-22, p. 14.
[116] *Ibid.*
[117] *Ibid.*
[118] Goldscheider, R. *et al.*, Use of the 25 per cent rule in valuing IP, 2002, Ies Nouvelles, pp 123-133 p 124.
[119] Smith, G.V. *et al.*, *supra* nota 58, p 412-415.
[120] *Ibid.*
[121] *Ibid.*

The last point of focus in the rule of 25% concentrates on fully loaded profits. Benefits generated by a property are most accurately measured after consideration of expenses.[122] A company's total expenses consist of manufacturing costs as well as from the variety of operating expenses associated with product activity, which are excluded from the gross profit calculations.[123] Fully loaded profits measure the accounting returns on a product, including the overhead expenses regarding product activity, and they may refer either to pre-tax profits or operating profits, based on how they have been calculated. [124] In pre-tax profit calculation costs of goods, nonmanufacturing overhead expenses and other incomes and expenses are reduced from the revenue.[125] Operating profits are calculated by reducing only the costs of sold goods and nonmanufacturing overhead from the revenue. The variation in profit calculation fluctuates for example on the basis on how the company is financed.[126]

### 2.1.2. Relief from Royalty

The relief from the royalty method valuates the royalties on the basis of future incomes. The method is based on the idea that an intellectual property right's owner licenses the intangible right for another intra-group company and the theoretical price of the royalty rate is then the price that is paid back to the owner.[127] The method is highly appreciated, because it calculates the value on the basis of documented, independent party transactions and it can be done based on a company's available financial information and because it is applicable for many types of intellectual property rights[128].

The value of the royalty is hereby the net value of the future royalty savings or potential royalty payments and the valuation starts by determining a brand's economic value by intangible specific financial data. The process then requires the identification of the market demand and intangible's position there with regards to other comparable competitors. After market analysis, a conceptual royalty rate shall be established and future incomes calculated for each intellectual property right individually. An asset's brand, size, reputation and recognition are taken into account to obtain a brand-specific discount rate. With the help of this rate, future incomes are

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[122] *Ibid.*
[123] *Ibid.*
[124] *Ibid.*
[125] Smith, G.V. *et al.*, *supra* nota 58, p 414.
[126] *Ibid*
[127] PWC, Intangible Asset Valuation, 2014, pp 1-16, p 6-8 . www.wipo.int/edocs/mdocs/sme/en/wipo_smes_lis_14/wipo_smes_lis_14_j_hadjiloucas.pdf (15.3.2017)
[128] *Ibid.*

discounted to their final form – net present value. The obtained value is expressed as a percentage of revenue.[129]

### 2.1.3. Comparable Uncontrolled Transaction Method

The comparable uncontrolled transaction method (CUP) is classic and the most direct arm's length method for intangible transfer pricing, where the intra-company's actual price for an asset must be the same or as comparable as it would be in between independent parties' transactions and comparable uncontrolled transactions.[130] CUP compares the actual prices of the transaction for the prices obtained from similar kinds of intangibles transactions. A similarity in profit potentials and a relation to the same product range or processes within the market improves the comparability.[131] Sometimes it is difficult to find an exact duplicate for the asset and then the price can be adjusted.[132] Required adjustments are made to the level of comparability of intellectual properties and for sale circumstances and the method should be applied only if adjustments result in a sufficiently similar pricing and the CUP is the best method available to a particular circumstance.[133] In licensing practical challenges arise from the arm's length determination for intangibles, since there are rarely open markets for trading intangible assets.[134]

### 2.1.4. Comparable Profits Method

The comparable profits method (CPM) is a profit-based transfer pricing method, which compares the profitability of charged transfer prices of a controlled entity with objective measures within market transactions within similar premises.[135] It seeks the transferred intangible's value by defining the controlled entity's operating incomes and uncontrolled entity's operating incomes and compares the corresponding transaction's profits between independent parties.[136] The method requires that companies comprising the arm's length should have the same level of comparability in their activities, risk and ownership.[137] The CPM uses multiple kindred transactions from which it generates certain profit levels.[138] The method seeks similarity

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[129] *Ibid.*
[130] Brauner, Y., *supra* nota 56, p 128-129.
[131] *Ibid.*
[132] Abdallah, W.M. *et al.*, *supra* nota 73, p 10-12.
[133]Brauner, Y., *supra* nota 56, p 128-129.
[134] Abdallah W.M. *et al. supra* nota 73, p 10-11.
[135] Brauner, Y., *supra* nota 56, p 130.
[136] *Ibid.*
[137] Abdallah, W.M. *et al.*, *supra* nota 73, p 12.
[138] Brauner, Y., *supra* nota 56, p 130.

with the help of profit level indicators, which provide the most suitable information about the business, such as costs, sales or resources and the most appropriate indicator is selected on the basis of which gives the best indication from future incomes.[139]

### 2.1.5. Profit Split Method

The profit split method (PSM) is a transactional profit method that focuses on whether the total business profit allocation is done in respect of the arm's length principle between the related parties.[140] The method identifies the total profits or losses to be split from the controlled intra-group transactions and then allocates those between the parties on an economically valid basis of how independent parties would have shared the profit.[141] For the allocation, the scale of business activity must be clarified and then the profits allocated according to the activities.[142]

In this method's application, the factors and calculations of profit splitting must be determined on an *ex ante* basis, meaning that the information that should be known or could have been foreseen must be applied in the process.[143] According to the OECD's revised guidance on transactional profit splits, profit splitting requires full assessment of the companies' functions, where for example outcomes, ownership and the risks of related parties are considered and the information is shared. It rules, that profit can be split in two ways: either on the basis of whether the income is already received or not by combining and splitting the anticipated profits, or by the most appropriate method, which is combining and splitting the actual profits. There are two commonly used approaches for distributing profits. Contribution analysis divides profits on an reasonable approximation basis between related parties, which ensures that profit division is made arm's length in relation to independent parties, while residual analysis makes the allocation firstly on the basis of routine contributions in certain business activities and then the remaining profit is allocated between the parties on the grounds of the contribution's value to the business activity.[144] The PSM has been found good for the intangible valuation especially in cases where two or more related companies are sharing economically essential risks in their activities.[145]

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[139] *Ibid.*
[140] OECD, BEPS actions 8-10 revised guidance on transactional profit splits, 2016, pp 1-19, p 3 www.oecd.org/tax/transfer-pricing/BEPS-discussion-draft-on-the-revised-guidance-on-profit-splits.pdf (15.3.2017)
[141] OECD, BEPS actions 8-10 revised guidance on transactional profit splits, *supra* nota 140, p 3.
[142] Brauner, Y., *supra* nota 56, p 132.
[143] OECD, BEPS actions 8-10 revised guidance on transactional profit splits, *supra* nota 140, p 3.
[144] *Ibid.*
[145] *Ibid.*

The quantification of assets by traditional transaction methods is difficult because assets are seldom identified as a separate factor and the companies within intra-group transactions form relatively tight relations with each other.[146] PSM emphasises the financially stable, two-way relationship between transactions in the arm's length standard, and the profits reflect the actual contributions from each party.[147] The profit split method takes into account specific factors that cannot be assessed between independent enterprises.[148] Related parties can have a business advantage from unique information that is not available for independent parties while they are still applying the arm's length principle.[149] The difficulties arise from the actual application of the method. It may be challenging to combine the relative information regarding revenues, costs and profits from foreign subsidiaries. Drafting a detailed analysis from the past, current and upcoming transactions from MNE may also be difficult to access and interpret. The profit split method is also criticised for focusing on routine transactions, when the most common non-routine transactions for intangibles are ignored.[150]

### 2.2. Difficulties in Royalty Rate Valuation in Transfer Pricing

Royalty rate valuation is a comprehensive process. In addition to the discussed difficulties in the particular method itself, the process includes some other challenges. The use of the arm's length principle requires a large amount of reference data and so the practical implication of the data can be challenging.[151] Assets' quality, characteristics and availability affect its comparability and even slight differences in the asset can affect the price in a way that transactions are no longer comparable.[152] This establishes challenges especially with intangibles, where the level of comparability is low. The difficulty in proving the successful application of an arm's length transfer price for intra-group transactions causes problems in royalty rate valuation. When applying a comparable transaction's valuation methods to the new royalty rate valuation, the result still might not be satisfying or fully comparable.[153] Every intangible transaction has its own unique features and poor comparability can cause differences in transactions' interpretation.

[146] *Ibid.*
[147]Brauner, Y., *supra* nota 56, p 132.
[148] OECD, BEPS actions 8-10 revised guidance on transactional profit splits, *supra* nota 140, p 3.
[149] Abdallah, W.M. *et al*., *supra* nota 73, p 13-14.
[150] Visconti, R.M., *supra* nota 76, p 218-219.
[151] OECD Transfer Pricing guidelines (2010), *supra* nota 8, p 41-42.
[152] *Ibid*
[153] Viding, S., *supra* nota 107.

Different premises give different possibilities for valuation and interpretation. Parties may have dissenting interpretations of the property in valuation in transfer pricing. The owner of the intellectual property rights and hereby the royalty recipient has their own interpretation of the value of the property, whereas the party paying royalties can see the value from a very different perspective, even though the objective between those parties would be kindred.[154] Therefore for example emotions towards one's own brand or trademark might affect the valuation. Differences in interpretation can occur between the tax authority and the intra-group company in question. Whereas a company's aim is to price transactions in a way that it produces the lowest taxation possible, tax authorities look for the best solution for the country's economy in total. Hereby it is important to have an objective evaluation of what the independent party would really be ready to pay from the property.

The size of royalties is determined arm's length and certainty of the success of valuation can be ascertained through the advance pricing agreement (APA) [155] awarded by the tax authority. The decision given by the authorities through the APA process is binding and therefore it is the only truly accurate way to ensure success in pricing.[156] Companies can apply APA either from one country in the process or from every country involved and within the means of this affect the level of certainty in taxation in different countries.[157] Difficulties occur when not every country is part of the APA and thereby a company in such a country is in an unequal position among the others. Companies might also have different possibilities for applying for APA, as for example bigger corporations have better economic qualifications for the application process. In addition to the actual application fee, the valuation process itself requires companies to have or acquire special expertise from a narrow sector and unfortunately not all small companies have such expertise in their company.

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[154] Choi, W. *et al.*, Transfer pricing, Incentive Compensation and tax avoidance in a multi-division firm, Boston, Review of Quantitative Finance & Accounting 11(2). Kluwer Academic Publishers, 1998, pp 139-164 p 139.
[155] Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee on the work of the EU Joint Transfer Pricing Forum in the field of dispute avoidance and resolution procedures and on Guidelines for Advance Pricing Agreements within the EU{SEC(2007) 246}
[156] *Ibid.*
[157] Sikka, P., Willmott, H., The dark side of transfer pricing: Its role in tax avoidance and wealth retentiveness, United Kingdom, Critical Perspectives on Accounting, 2010, 21(4), pp 342–356 p 343.

All in all, there is no single way to valuate royalty rates in transfer pricing, which is one of the major reasons for the variations in the valuation process. Different companies have different premises for succeeding in the valuation process. The process itself is money and time-consuming and it requires professional intra-group participation and in big MNE corporations the process might even be done multiple times so the result satisfies all the parties.[158] A lack of available information can set limits on the valuation process and for example a scarcity of industry specific data in databases may cause a special requirement from the business area to not be able to be taken into account in the valuation process.

[158] Viding, S., *Supra* nota 107.

## 3. The Size of Royalty Rate with Regards to Tax Avoidance Legislation

Without supervision, intra-group transactions could be used to manipulate costs, incomes and profit transfers in order to minimise taxes in the different companies or within the whole group.[159] Profits could be transferred from a high tax state to a more favourable state or from a more profitable company to an economically weaker company.[160] Transfer pricing is often perceived as a means of tax avoidance, but it should be noted that transfer pricing is not itself a tax avoidance vehicle but like in any other business arrangement, the possibility for using it wrongfully exists. When transfer pricing is not done in accordance with the arm's length principle, tax liabilities and therefore tax revenues can be distorted.[161] In order to evaluate the success of a royalty valuation in a transfer pricing process from a tax avoidance perspective, it is important to contemplate legislation and related rulings precisely. The relation between an appropriate royalty rate and tax avoidance can hereby continue by examining the limits of how Finnish legislation regulates tax avoidance.

### 3.1. Taxation of Royalty Payments in Finland

International tax treaties aim to prevent double taxation in cross-border business transactions and the model tax convention regulates that royalties are taxable only in one contracting state.
Cross-border tax processing for royalties depends on domestic tax law, tax treaties and EU law and the taxation of royalties is determined on the basis of tax treaties between Finland and the country in question.[162] Tax treaties often legitimate the source state to tax royalties according to a specific percentage. Finnish tax law is based on the principle of separation, which underlies on the idea that all incomes, expenditures and assets must be allocated rightfully to that intra-group company to which the expenses regarding the income generation are related.[163]

The taxation of royalty income varies according to the relationship of ownership between the recipient and the payer, the payer's home state and according to whether the income relates to the Finnish company's permanent establishment in the income's source state.[164] In Finland, tax liability is separated into unlimited and limited liability to tax in income taxation. Unlimited tax

[159] Glahe, M., Transfer pricing and EU fundamental freedoms, The Netherlands , EC tax review Kluwer law international BV, 2013/5, pp 222-232 p 222-223.
[160] *Ibid.*
[161] OECD Transfer Pricing guidelines (2010), *supra* nota 8, p 32.
[162] Helminen (2002), *supra* nota 13, p 221.
[163] Helminen (2000), *supra* nota 1, p 5.
[164] Helminen (2002), *supra* nota 13, p 2.

liability concerns Finnish residents, while limited tax liability concerns taxpayers living abroad.[165] Company with unlimited tax liability is obliged to pay taxes from the incomes derived from Finland and abroad. If a royalty is obtained from abroad or it is associated with company's permanent establishment on abroad, the taxpayer is obliged to pay the taxes to Finland.[166]

A taxpayer with limited tax liability pays taxes only from the incomes obtained from Finland.[167] The source state of royalty is Finland, if income is used for sales in Finland or if the payer is a Finnish resident, company, companionship or estate. When royalties are paid abroad for a company with limited tax liability, the payer is obliged to withhold tax from the income, if directive 2003/49/EC on interest and royalties does not prohibit the payment.[168] The tax paid is 20% if the income recipient is community, 30% if income recipient is a natural person or 30% if the income recipient cannot be identified at the time of payment.[169] A company is exempt from interests tax withholding if the royalties are royalties within the meaning of Directive 2003/49/EC on interest and royalties or if the tax treaty enables a lower tax rate or the income is exempt from the withholding tax.[170]

### 3.2. Analysis on the Limits between Acceptable Tax Planning and Tax Avoidance of Royalties

The limit between acceptable tax planning and illegal tax avoidance is especially important to be identified in business transactions. Different EU member states have different standpoints on acceptable tax planning and tax avoidance and the European Court of Justice can ultimately solve the discrepancies on views.[171] Directive 2003/49/EC on interest and royalties only regulates cross-border transactions within associated companies and it only applies when the

[165] Finnish Tax Administration, Taxation of Earned income of nonresident individuals: Tax at source or progressive tax, (www.vero.fi/en-US/Precise_information/International_tax_situations/Taxation_of_the_earned_income_of_nonresi(30756)) (15.3.2017)
[166] *Ibid.*
[167] Gunn, A., Tax avoidance, Michigan Law Review, 1978, 76(5), pp 733-767 p 743.
[168] Suomen Verohallinto, A31/200/2017, Rajoitetusti verovelvollisen osingot, korot ja rojaltit, www.vero.fi/fi-FI/Syventavat_veroohjeet/Kansainvaliset_tilanteet/Rajoitetusti_verovelvollisen_osingot_kor(42397) (15.3.2017)
[169] *Ibid.*
[170] *Ibid.*
[171] Merks, P., Tax evasion, tax avoidance and tax planning, Amsterdam, The Intertax 34(5), Kluwer Law International, 2006, pp 272-281 p 281.

pricing of the transaction is done in respect of the arm's length principle.[172] EU law should not be applied in case of tax avoidance whereas national legislation comes applicable.[173]
The national legislation's special provisions are applied if royalties are overpriced or undercut from the arm's length principle and in Finland, this particularly means articles 28 and 31 in VML within the context of transfer pricing.

The attestation of the limit between acceptable tax planning and illegal tax planning is not straightforward. A taxpayer, a legal entity or a private person is entitled and on the other hand from the company owner's perspective also obliged to tax planning. The aim of tax planning is to minimise the payable taxes from the company's transactions and by tax planning an entity can choose itself the economically best option from the options that tax law allows.[174] When a taxpayer is doing tax planning for genuine legal commercial and economic reasons, the taxpayer is able to choose the kind of operation that produces the lowest possible tax burden. Successful cross-border tax planning requires in-depth knowledge of international and national tax law.

By minimising taxes, a taxpayer can also unlawfully pursue such measures that ultimately aim to prevent the payment of taxes. Tax avoidance is a breach of the law and thereby punishable. In criminal law, the *actus reus* and *mens rea* are important elements in determining whether action is unlawful.[175] Tax avoidance hereby can be determined by the analysis of whether there is a true arrangement, whose purpose could be seen solely as incidental and whether the regarded tax legislation was used against its genuine way of application.[176] Such measures made by the taxpayer that aim to purposely prevent the payment of taxation are considered as tax avoidance.[177] According to the OECD, tax avoidance and evasion are practises that are done against fiscal equity and lead to distortion of competition, cash flow and have budgetary effects.[178] Here, the OECD states that it is acceptable for companies to conclude tax planning but whereas a taxpayer purposely does not provide a report on particular transactions with the aim of

[172] Terra, B., *et al*. (2005), *supra* nota 24, p 525.
[173] Michlits, M., Anti-Abuse rules in the merger, parent-subsidiary, and interest and royalty directive, Vienna, Limits to tax planning, Lang, M. (ed), Series in International tax law (79), Linde, pp 1-613, p 587.
[174] Merks, P., *supra* nota 171, p 272.
[175] Mullineux, J., The distinction between tax avoidance and tax evasion, New Zealand, New Zealand Universities Law Review, Thomson Reuters property, 2014, 26(2), pp 260-296, p 276.
[176] Mullineux, J., *supra* nota 175, p 281.
[177] Blair-Stanek, A., Intellectual Property Law Solutions to Tax Avoidance, Maryland, UCLA law review, 2015,62(1), pp. 1-67, p 5.
[178] Merks, P., *supra* nota 171, p 273.

avoiding taxation, or if the payment itself is illegal, it cannot be considered tax planning or legal tax minimising.[179]

### 3.2.1 Interpretation of Articles 28 and 31 of the VML

The limit from moving away from acceptable tax planning to circumvention of taxes cannot be precisely defined in royalty rate transfer pricing according to Finnish law. A general and only clause for tax avoidance in Finland is regulated in *Verotusmenettelylaki §28*.[180] According to the VML, if some condition or action is given such a legislative form that does not comply with the actual character or meaning of the condition, the taxation must still be done according to the condition or action where the form is right. If some purchase price, action, compensation in an agreement or arrangement is done with the clear intention of avoiding taxes, the taxable income and property can be evaluated. This subsection 1 provides the scope of the anti-avoidance provision. According to the act, if it is obvious that the action's taxation should have followed in subsection 1, the author is obliged to carefully examine all the factors that may influence criticism and give the taxpayer an opportunity to provide clearance from the detected factors. If the taxpayer hereafter fails to give clearance that the legislative form of the condition or action corresponds to the actual nature or purpose of the condition or that the arrangement is not done with the intention of avoiding taxes, taxation must proceed according to the regulations of subsection 1.[181] The 1st subsection regulates the scope of application of the law including income taxation.

According to the Sampo Viding, 28§ of the VML includes formative difficulties.[182] The article gives a general ruling to all transactions and even if there are some specific rulings for tax avoidance in some business arrangements in Finland, for royalty rate transfer pricing there is none.[183] If a company has a genuine commercial reason for some arrangement, the arrangement is excluded from the scope of §28 and thus it is not tax avoidance.[184] In practice this means that justifications for the lack of a commercial reason in the royalty rate transfer pricing process are particularly important. Legislation does not provide an exact limit for an acceptable royalty rate

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179 *Ibid.*
180 Suomen verohallinto, A126/200/2014, Veron kiertämissäännöksen soveltaminen, www.vero.fi/fi-FI/Syventavat_veroohjeet/Verohallinnon_ohjeet/Veron_kiertamissaannoksen_soveltaminen (25.4.2017)
181 *Ibid.*
182 Viding, S., *supra* nota 107.
183 *Ibid.*
184 *Ibid.*

in the transfer pricing process and when tax avoidance legislation is indistinct, other indicative means for setting the limit may become applicable and limits for the royalty rate in transfer pricing can be determined with the help of precedents and tax authorities' prior decisions.[185] For such an important issue as tax avoidance, the strength in a general ruling is that it includes multiple transactions within the companies. However, as transfer pricing is a complex ensemble with no exact limitations given by the law and interests might conflict within the parties, no exhaustive answer regarding the way or scope of legislation's application can be given.

It should be noted that 28§ of the VML is expressly a tax avoidance regulation and its purpose is not to interfere in tax planning anyhow and from this perspective, hereby the VML can be considered to be consistent and it includes all situations where an intra-group transaction is reasoned.[186] During the research, the author found out that multiple articles were considering intellectual property right valuation in transfer pricing as an instrument in international tax planning and only a few considered it precisely as a means of tax avoidance. The most important findings regarding that was that tax avoidance in royalty rate transfer pricing is mainly a question of whether there is a basis for a certain transaction or instalment at all,[187] whereas the considerations of a specific limit for a royalty rate in valuation plays a smaller role.

The definition of tax avoidance could be used in situations where a party does not have the right to receive royalties from an intellectual property right, but is still receiving them. On the other hand, if a party has the right to receive royalties, but those are not priced according to the arm's length principle, it can also be considered as an act that requires transfer pricing adjustments within the meaning of VML §31.[188] According to Sampo Viding, this is not necessarily tax avoidance, but hence a technical failure in the valuation process. VML §31 applies when the income or contract from the transaction between the related parties deviates from the transaction between completely independent parties and if the arrangement has made the payable income from the transaction smaller or the loss greater; the taxpayer is obliged to pay the difference.[189] Regulated compensation in the case of incorrect valuation is truly substantial and in Finland, the regulation regarding the adjustments can be said to be successful in a way that substantial

185 Suomen verohallinto A126/200/2014, *supra* nota 180.
186 Viding, S., *supra* nota 107.
187 *Ibid.*
188 Suomen verohallinto (2005), *supra* nota 42.
189 *Ibid.*

sanctions encourage companies to use precise valuation.[190]

For some specific circumstances, tax avoidance is regulated with context-sensitive rulings. For example *laki elinkeinotulon verottamisesta* (EVL) 24.6.1968/360 applies for business transactions such as for example merger, distribution, partial distribution or exchange of shares. The EVL regulates that all incomes derived from business activities are taxable and §52h gives prerequisites for tax avoidance, which are that an arrangement must be obvious, implied and at least one of the main purposes of the arrangement.[191] This law is applicable only to transactions concerning business arragements, but still it stresses the importance of the action's intention as a substantial factor in the determination of tax avoidance.[192]

### 3.2.2 Tax Avoidance in Royalty Transfer Pricing

As the author demonstrated previously, tax avoidance in royalty rate transfer pricing is mainly a question of whether there is a basis for a certain transaction or instalment at all. Tax can be avoided by creating unjustifiably artificial transactions within intra-group companies.[193] A company can practise profit shifting for example by alienating the right to use a particular intellectual property right to its subsidiary, to which it does not have any actual legal or commercial entitlement.[194] With this kind of arrangement, a company can evade the license of the asset unnecessarily in a country with a low tax rate and ultimately then end up having royalty payments paid back as tax-free dividends. In such situations, it is important to evaluate whether the only purpose of such transactions has been tax avoidance or if there is any other incentive for such transactions. In these kinds of illegal arrangements the success in arm's length pricing is no longer a relevant issue to evaluate.[195] Another way then for tax avoidance is deliberate failure in the valuation process itself. Companies may valuate their intellectual property rights according to their own agendas due to which the royalties can be undercut or overpriced. Here, the reasoning behind the valuation of royalties becomes particularly important.[196]

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[190] Viding, S., *Supra* nota 107.
[191] Suomen verohallinto, A110/200/2015, Yritysjärjestelyt ja verotus-liiketoimintasiirto, www.vero.fi/fi-FI/Syventavat_veroohjeet/Elinkeinoverotus/Yritysjarjestelyt_ja_verotus__liiketoimi (25.4.2017)
[192] *Ibid.*
[193] Suomen verohallinto A126/200/2014, *supra* nota 180.
[194] Dischinger, M, Riedel, N. Corporate taxes and the location of intangible assets within multinational firms. Journal of Public Economics. 2011, 95(7/8), pp 691-707 p 699.
[195] Viding, S., *Supra* nota 107.
[196] Blair-Stanek, A., *supra* nota 177, p 9.

Finnish law regulates disguised dividend distributions in VML §29. Disguised dividend distributions are such income distributions within the shareholders in a company that ignore the formal requirements of profit transfers and hereby their nature corresponds to actual profit distributions.[197] In these cases, the company's shareholder has gained such a benefit that would not have been gained between independent parties and thus is disguised dividend distribution.[198] From the point of view of royalty valuation in the transfer pricing process, the dividend distribution could be priced in a way that would not again be possible between totally independent parties and the parties would be obliged to compensate for the loss within the meaning of VML §31 on transfer pricing adjustments.

When speaking of tax avoidance via royalty rates, tax havens are often also taken into discussion. The discussion is particularly important and the OECD also emphasises the importance of tackling tax havens in the report on harmful tax competition.[199] A country that provides more favourable taxation or other economic or legal conditions to a taxpayer is often preferred as a tax haven. Havens are developed in times due to their links to some other country for historical or geographical reasons.[200] High secrecy and developed professional assistance over financial concerns, advanced infrastructure and lack of currency controls are characteristic of tax havens and they provide different kinds of relief concerning for example incomes, import duties, estates or very specific transactions.[201] For royalties, havens may be used with regards to income transfers.

A corporation may also establish controlled foreign companies (CFC) to low-tax countries. This foreign company works between a company that otherwise would receive income and the company that pays income. With this arrangement, intra-group companies might try to avoid taxes in the income receiver's country as well as in the country of the payer.[202] CFCs might collect income derived originally from the transaction belonging to another country according to the source principle. A corporation can transfer its holding securities and intellectual property rights to these controlled foreign companies and collect interest, capital gains, dividend income

[197] Suomen verohallinto A126/200/2014, *Supra* nota 180.
[198] Suomen verohallinto A126/200/2014, *Supra* nota 180.
[199] Orlov, M., The Concept of Tax Haven: A legal analysis, The Intertax Kluwer Law International, 2004, 32(2), pp 95-111 p 95.
[200] *Ibid.*
[201] *Ibid.*
[202] Helminen, M. Kansainvälinen tuloverotus, Helsinki, Edita Publishing Oy, 2009, p 183.

and royalties derived from those to the company. Income derived from these transactions may never be paid to the owner's country of residence and hereby they avoid the payment of taxes there. Income can also be paid in such a form that a foreign company's place of residence cannot tax it as the source state or the income recipient cannot tax it either as secondary sheltering. Payable tax can also be substantially lower because of treaty shopping.[203] Tax regulations are not uniform and thus tax authorities are not able to compare the received fiscal information with rulings. The information flow regarding tax havens is also inadequate. When a company transfers income between two countries, for example with the help of CFC, the resident party's (third country in this case) might not receive any taxes even though the income would be owner by the resident. This is because of high bank secrecy, which demands that the transaction be covered.[204]

### 3.2.3. Significance of Preliminary Rulings in Taxation

The taxpayer has the right to acquire a binding preliminary ruling from case-related interpretation of legislation from the Finnish tax authorities.[205] The process of applying binding preliminary declaration can be time-consuming and often special expertise for valuation is needed.[206] As Finnish tax legislation consists of general provisions regarding tax planning and avoidance, authorities can provide a declaration for a taxpayer to ensure the exact tax treatment of the particular measure or transaction beforehand.[207] This procedure is regulated in article 85.1 of the VML. Here tax authorities give foreknowledge on a basis of a taxpayer's application and extensive clearance from the issue in concern.

A preliminary ruling is particularly important in royalty rate valuation in transfer pricing since there are no exact instructions concerning them. A ruling is also important from the perspective that it reduces unwarranted appeals.[208] When the actual transaction corresponds to the preliminary ruling's conditions, the tax authorities are obliged to tax the taxpayer according to the decision. It is widely applied to international corporations' transfer pricing issues, disguised dividends and tax avoidance issues.

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[203] Helminen (2009), *supra* nota 202, p 184.
[204] Avi-Yonah, R., Globalization, tax competition, and the fiscal crisis of the welfare state, Harvard, Harvard Law Review 113(1573), 2000, pp 1573-1676 p 1584.
[205] Myrsky M. Ennakkopäätökset verotuksessa, Helsinki, Talentum Media Oy, 2011, p 112.
[206] Helminen (2000), *supra* nota 1, p 187.
[207] Myrsky (2011) *supra* nota 205, p 114.
[208] *Ibid.*

### 3.3. The Supreme Administrative Court Decisions in Determining Arm's Length Royalty Rate in Transfer Pricing

In Finland legal sources are divided into written law, conventional law, precedents and legal science. From these, written and conventional law formulate binding legal sources, while the precedents and legal science are secondary and advisory rulings. However, when self-regulatory law does not provide a legislative basis for resolving a problem, secondary rulings and especially precedents may become applicable.[209] Precedents and legal science are not binding rulings for courts to apply, but rather indicative and they have pronounced meaning especially within taxation laws.[210] If the solution is not specified in article 28 of the VML, precedents can be used to get significant refinements for the specific subject area. Eventually, alongside legislation, the line of solution in precedents stabilises and gives clearer instructions for handling these kinds of issues than how legislation concerns the issue alone.[211] Regardless of the good comparability of the precedent to the case in question the Court of Justice ultimately decides whether valuation is done in respect of the arm's length principle and whether the size of royalties is proficient.

The Administrative Court (HAO) decides whether the judgement of a contested decision is lawful. The Supreme Administrative Court (KHO) as the highest Administrative Court in Finland considers all the senior secondary applications and appeals from the Administrative Court concerning taxation in Finland. The Administrative Court and the Supreme Administrative Court together constitute the basis for precedents in Finnish tax law issues.[212] As there is no precise limit for a legitimate size of royalties in the transfer pricing process, the precedents construct a basis for example for the evaluation of successful application of the arm's length principle and the measure's legitimacy as a means of tax planning. However, there are none or only a few precedents regarding outright tax avoidance in royalty rate valuation in the transfer pricing process and therefore precedents concentrating on for example transfer pricing adjustments in VML §31 can be used for exploration of different policy options for acceptable royalty rates. Important Finnish precedents concerning transfer pricing or royalties are the

[209] Myrsky, M., Prejudikaattien merkitys verotuksessa, Helsinki, Lakimiesliiton kustannus, 2002, p 1-4
[210] *Ibid.*
[211] Myrsky (2002), *Supra* nota 209, p 35.
[212] Myrsky (2002) *Supra* nota 209, p 39.

KHO's decisions 1999/4219 and 2010/73. The author has also dealt with the issue with the help of the Administrative Court's decision HAO 14/1003/4 (2014).[213]

The interpretation of VML §31 on transfer pricing adjustments and the line between tax planning and tax avoidance may be clarified with the KHO's 2010:73 decision.[214] The case considers arm's length prices with regards to interest, whereas one of the intra-group company's subsidiaries, company A Oy, took two loans from a totally independent party with a total interest rate of 3.135-3.25 percent. The company's long-term loans were then 36 million euros and its own deposits 41 million euros. After the company's financial readjustments, the group's financial partner, Company B AB, provided a new loan with a total interest rate of 9.5 percent. The amount of Company A's long-term loans increased to 38 million euros and their own deposits were then 300 million euros. There were no other valuable changes in the capital structure that would have explained the amount of interest from the new arrangement. Hereafter the interest paid from A Oy to B AB remarkably exceeded the amount that would have been paid between totally independent parties. Contrary to VML 31§, A Oy diverged from the conditions that would have been made between independent parties with regards to interest and hereby was obliged to reimburse the difference from realised interest of 9.5% and legitimate interest of 3.25%.

In the KHO's decision of 27.12.1999/4219 Company A had licensed the right of the use of a trademark for its subsidiary in the Netherlands (Company B).[215] According to the licensing contract, Company B was obliged to pay 2 percent royalties from the annual net income and dividends to Company A. Royalties and dividends together constituted approximately 4 percent from the net sales. B had made a sublicensing contract with other intra-group companies in Finland, which were obliged to pay royalties to B worth 5 percent of annual net sales. The Administrative Court agreed with the Finnish tax authorities' decision that the licensing contract and royalties were undercut from the arm's length principle. With a sublicensing arrangement, subsidiaries paid 5% royalties, which they could reduce from their taxable incomes as expenses. Hereafter Company B paid gained royalty income as tax-free dividends to the parent company, Company A. The court ruled that such arrangements were done apparently with the purpose of

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[213] Mehtonen, P., Siirtohinnoittelu, tuloverotus ja konsernistrategiat, Helsinki, Edita publishing Oy, 2005, p 223.
[214] Myrsky (2011), *Supra* nota 205, p 175.
[215]Korkein Hallinto-Oikeus, 27.12.1999/4219, www.edilex.fi/kho/lyhyet_ratkaisuselosteet/199904219?offset=1&perpage=20&phrase=Osingot&sort=timedesc&typeIds[]=8&searchKey=285287 (15.2.2017)

avoiding taxes and that such rulings would not have been done between completely independent parties.

The Administrative Court of Helsinki (HAO) has dealt with transfer pricing, royalties and arm's length price in its decision 14/1103/4 on 10.10.2014. Here, intra-group companies from Finland (Company A) and another company from Switzerland have a licensing agreement regarding the use of the name and the trademark of the company in Finland.[216] Company A has used the trademark since 1989 and the name of the company has included the enterprise's name. The case considered whether Company A's payments to the Swiss company were tax-deductible according to VML §31. The Administrative Court ruled that the enterprise's name, trademark, mission and values were common for all companies within the group, and therefore such benefits were not chargeable. However, the charge could be justified if one party could prove that it had gained economic benefits from the contract of use of such intellectual property rights.

What makes the case particularly interesting from the point of view of royalties is that the company started to price the use of those intangible rights only in 2004. Even though this fact itself does not mean that the tax would not be deductible, it certainly is an important aspect if there are no remarkable changes in the operative environment or in the company's market position. The Administrative Court ruled that the Swiss company had not participated in marketing, brand or product creation in any means and thus was not eligible to receive any compensation from those. Regarding the arm's length principle, transactions between intra-group companies, such as in this case, should be priced in a way that totally independent parties would price their transactions. Company A could not either reliably prove or provide clarification that the Swiss company had substantially invested in the intellectual property right's creation. Hereafter, the court ruled that the company had not received such benefit from which payments would be justifiable and thus taxes could not be considered deductible.[217]

[216] Helsingin Hallinto-Oikeus, 10.10.2014, 14/1103/4, www.oikeus.fi/hallintooikeudet/helsinginhallinto-oikeus/fi/index/hallintooikeusratkaisut/hallintooikeusratkaisut/1413204679626.html (15.2.2017)

## Conclusion

Transfer pricing is a concept for ensuring that associated companies price their intra-group intangible or tangible transactions with the same principles as totally independent entities. Nowadays transfer pricing transactions are significant as they are the most common of all transactions in the world, and thereby tax-related considerations are relevant. A company's property was previously formulated mostly from material property. Today, intellectual property rights are an important part of a company's own capital. Significant parts of the value of international companies' transactions are derived from intellectual property rights transfers. In a transfer pricing context it should be noted that a transaction, either the alienation of the property in total or licensing, must truly create essential and verifiable value to be recordable as a company's intellectual property. Intellectual property rights offer, by their very nature, completely different possibilities for companies to abuse transfer pricing rules. As this thesis has shown, intangible assets' characteristics make them easily movable and difficult to approximate, whereas tangible assets are easily defined and measurable.

International tax laws deal with the extent to which sovereign states are able to reach their national tax legislation requirements. The growth of international transactions sets challenges in transfer pricing and international taxation, since companies are under different states' legislation and administrative requirements. The concept of transfer pricing is regulated in many conventions, which all aim to ascertain common and fair tax treatment to the parties. For example, the EU Arbitration Convention concentrates on elimination of double taxation between associated companies and it regulates the reciprocal relationship between the contracting states and gives competence to the relevant tax authorities. The Subsidiary-Parent directive also regulates double taxation, but in a more specific field by aiming to remove double taxation from multinational entities in withholding taxes on payments of dividends between the parent company and its subsidiaries.

The model tax convention formulates the basis of bilateral tax treaties between OECD member states and between OECD member states and non-member states. From these, the most practical rulings can be obtained from the transfer pricing guidelines. In OECD member states, companies are obliged to follow OECD transfer pricing guidelines in transfer pricing. The guidelines are not binding in law but are in practice widely applied and respected. The guidelines regulate how transfer pricing should be taken into account on assessment procedures within member states' own legislation and how the arm's length principle should be adapted. EU member states have retained broad sovereignty over deciding their direct national tax regulations and this provides a basis for speculation of law. Transfer pricing rulings and tax legislation seek to ensure equality of taxation between companies and hereby decrease possible loopholes from this process.

Transfer pricing is a complex ensemble especially when an intangible asset is the object in a transaction and obtained profits are paid as royalties. Rulings regarding choosing a valuation method are imprecise and difficult to apply in practice. The general definition referred to in this thesis for a reasonable royalty rate is that it is the amount that a licensee is willing to pay the licensor for the use of an invention while still gaining a reasonable profit from it. As there is no internationally accepted limit for royalties, different states may have different definitions of the term and it may cause a conflict in interpretations and international double taxation. Royalty rate valuation can be done in many ways and the most important requirement for that is that the obtained price be arm's length. Application of the arm's length principle for royalties requires that the object, terms and conditions of licensing, as well as the licensee's business actions, resources and risks are to be analysed. Determination includes deep analysis of the nature of comparable controlled transactions and information regarding the use or transfer of intangibles.

There is no single way to valuate royalty rates in transfer pricing, which is one of the major reasons for the variations in the valuation process. Valuation should be done by using the best model for the transaction in question and thus always on a case-by-case basis. Finding a comparable transaction for an intangible asset under valuation is extremely essential in the royalty valuation process. The practical qualification of the price is often difficult because multinational companies are under different jurisdictions and the operations, incomes and expenses are highly integrated. In real life valuations, truly comparable transactions are also rarely found. Some classic transfer pricing methods are particular to royalty rates and the most suitable method can be found after a comparison of the model's strengths and weaknesses. Intellectual property rights in general are most commonly valuated with the income, market or cost approach, which measure the value that an asset will generate in the future, compare existing market prices, or estimate the costs of a comparable object. The most recognised methods for royalty rate transfer pricing consist of the relief from royalty method, comparable uncontrolled transaction method, comparable profit method and profit split method. Valuation must include evaluation of the appropriateness of the method with regards to a specific nature of the transaction, level of comparability, standard of knowledge and consideration of possible adjustments. Company-based conditions shall be estimated exhaustively.

Methods give different premises for valuation. The 25% rule sees that the licensee is entitled to get 75% of the profit whereas the licensor receives 25%. Within this method profits are mostly settled in advance from the basis of the parties' assumed inputs. Because of the greater risks, the licensee stands to receive a larger amount of profit. The CUP method emphasises the use of the arm's length principle in intangible valuations and the relief from royalty method valuates royalties on the basis of future income. The relief from royalty method is an income-based method, which looks at valuation from the point of view of future royalty income, and both the comparable profits method and profit split method acquire the transfer price via obtained profits. Where CPM compares the profitability of the transfer prices between a controlled entity and market transactions, PSM focuses on the arm's length profit allocation between related parties.

Transfer pricing, especially with regards to intangibles, has long been recognised as a possible tax avoidance tool within multinational entities. The aim of the business is to generate profit for its shareholders and tax can be seen as one cost among other costs. Even the limit between tax avoidance and tax planning is difficult to adjust because no qualified limit for tax avoidance is given. There are multiple options to arrange business transactions and it is the taxpayer's right to choose the most efficient option available to themselves. However, a taxpayer must be able to justify their arrangements with truly commercial reasons.

Tax planning seeks to find the most economically advantageous alternatives for companies to carry out their business. By tax planning, a company can considerably affect its expenses whereas the business income remains greater. Tax planning can be either passive or aggressive in its nature and all the forms within the scope of planning are still lawful**.** The ruling for tax avoidance is concise and imprecise and thus gives wide discretion for the person applying the law. However, even though the ruling itself does not provide the exact limit for unlawful royalty rates, the idea behind it is still clear. A company's genuine reason behind the transaction in question is the most important starting point when valuating if a transaction falls under the definition of tax avoidance. Such operations that are made with the purpose of avoiding payable taxes are considered as tax avoidance, and it is important to emphasise that tax avoidance is a question of whether a taxpayer has a basis for a certain transaction or instalment at all. Here the concepts of *actus reus* and *mens rea* are applied. A company may also fail in the actual valuation process if the royalty is either too low or high, but this should instead be considered as a technical failure, which could be indemnified afterwards, rather than tax avoidance itself. However, companies may valuate their intellectual property rights according to their own unlawful agendas, due to which royalties can be undercut or overpriced and here the transaction is tax avoidance. Artificially transferred profit shifts can be done by alienating the right to use a particular intellectual property to its subsidiary, whereas it otherwise would not have any actual legal or commercial entitlement.

EU law should not be applied in case of tax avoidance, and thus in overpricing and undercut taxation situations, it shall be interpreted from the point of view of VML 28. Article 28 gives a general ruling to all transactions and even if there are some specific rulings for tax avoidance in some business arrangements in Finland, for royalty rate transfer pricing there are none. A transaction's tax treatment can be identified with the help of preliminary rulings, where tax authorities give a binding solution for tax-related transactions. These rulings are particularly important for royalty rate transfer pricing situations whereas the law does not prescribe a straightforward solution. Precedents can also be used when interpreting legal problems regarding taxation and they may construct a basis for example for the evaluation of successful application of the arm's length principle and the measure's legitimacy as a means of tax planning.

The hypothesis made by the author is correct. The findings reveal that the size of the royalty rate in transfer pricing that is considered as tax avoidance is unclear according to the Act on Assessment Procedure (1558/1995) in Finnish law. However, even though the law does not give a size for unlawful royalty rates, it does give a definition for tax avoidance itself, and thereby the actual size does not even matter. The consideration of whether some transaction is tax avoidance should be measured by another means, while emphasising the purpose of the transaction. Tax avoidance matters are concerns of criminal justice and the application of the VML is always an exceptional and highly case-related concern. Unambiguous limitation is not even appropriate for defining whereas conditions, concepts, transferred royalty payments and objectives fluctuate according to each case separately. However, some conclusions from unlawful royalty rates could be drafted from a comparison of kindred transactions and assets dealt in court and a limit for royalties could be obtained that way.

In addition to interspersed analysis and legal study of acceptable royalty rates via international precedents, the author also sees other transfer pricing-related matters as extremely interesting for upcoming research. The author suggests that future fields of study could concentrate on comparisons of national tax avoidance legislation between different EU countries and broaden the current thesis subject for a more comparative analysis of how legislation regarding international transfer pricing in intellectual property rights and licensing differs between countries. Future studies of the subject area could also focus on qualitative analysis of the effects of accuracy of information on the intellectual property rights licensing process and the possibilities in today's society to use information technology with regards to that.

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