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Legal factors and components that influence an intellectual property valuation

Master's Thesis

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Contents

Acronyms

FASB	Financial Accounting Standards Board
IAS	International Accounting Standards
IASB	International Accounting Standards Board,
IASC	International Accounting Standards Committee
IFRS	International Financial Reporting Standards
IP	Intellectual property
IPR	Intellectual Property Rights
OECD	Organisation for Economic Co-operation and Development
TRIPS	Agreement on Trade-Related Aspects of Intellectual Property Rights signed in Marrakesh, Morocco on 15 April 1994.
WIPO	World Intellectual Property Organisation
WTO	World Trade Organisation

Introduction

Background.

As the World Trade Organization (WTO) observes, “Many products that used to be traded as low-technology goods or commodities now contain a higher proportion of [IP] in their value — for example brand-named clothing or new varieties of plants.”[1] Indeed, it is estimated that two-thirds of the value of large industrial companies now derives from intangible assets.[2]

It has only been a couple of decades since intellectual property was generally regarded as a rather obscure, but necessary, field of legal regulation. In the last few years, however, intellectual property has become recognised as the driving force of economic growth and cultural development. As a result, the law of intellectual property has entered the consciousness of an ever-widening part of the public, and is increasingly seen as a matter for public policy as well as for private exploitation.

Despite its growing importance, intellectual property remains a challenging area of law. This is because, unlike the laws of real property, the laws of intellectual property create rights between individuals that are vested in abstract objects – being objects that, inherently, are difficult to define. Furthermore, intellectual property is an ever-expanding field, and its role in society has become increasingly significant and complex.[3]

Intellectual property has become more, not less, complex in its substance and regulation by the law. Two-thirds of the value of large industrial companies derives from intellectual property and there is no law regulations and legal basis to estimate the value of this IPR, it is a fact of necessity of this thesis and its relevance. Furthermore, there is not carried out thorough research on this topic at the master’s thesis level before. This master’s thesis seeks to help bridge that gap, by explaining how intellectual property valuation is seen by the law and legal factors of the influence of an intellectual property.

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[1] World Trade Organization, Intellectual Property: Protection and Enforcement, http://www.wto.org/english/thewto_e/whatis_e/tif_e/agrm7_e.htm

[2] Menell, P., Scotchmer, S., Intellectual Property Law, in 2 Handbook of law and economics, A. Mitchell Polinsky & Steven Shavell, 2007, pp 1473-1570

[3] Van Caenegem, William, Intellectual Property, Butterworths, Australia, 2001, p. 4

Considerations and limitations.

The main problem lies in the fact that the valuation of the Intellectual Property has not been regulated by the law. There is no Estonian law authorizing the legal basis for the choice of IP valuation method. There exists only one relevant regulation of Minister of Finance about methods for determining the value of transactions conducted between associated persons, there paragraph 14 provides the choice of expense method for intangible property valuation.[4] This regulation is extremely limited and directed only to associated persons and does not cover all aspects for intellectual property valuation. It is not possible to apply this regulation as general provision for all kind of intellectual property and persons.

This Thesis will not focus on the weak and strong points of the IP valuation methods. This Thesis will consider legal situations where the legal basis for the choice of IP valuation method is extremely needed. Further, as the aim with this Thesis is to afford advice to legal practitioners working with intellectual property, author has sought to strike a balance between legal theories and practical considerations.

Research Questions.

In Estonia the protection of IPR is not a government priority, because there is no special law regulating valuation of IP value, but there is for example Land Valuation Act. It is a problem for people who are working with IPR. In author's opinion such valuation scale or method in law would be very helpful and would avoid ambiguity and uncertainty, and significantly improve the conditions of Estonian legal environment, in this Master's Thesis author proves this statement.

The underlying hypothesis for this Thesis is that the valuation of the Intellectual Property value has not been regulated by the law and the need for such regulations of method choice in law is obvious.

The author of the Master's Thesis has set the following questions for analysis:

1. Is the valuation of the Intellectual Property value is regulated by the law unambiguously?
2. Can the transfer price of IPRs affect the value of IP and be a basis for tax avoidance?

[4] Minister of Finance, Methods for determining the value of transactions conducted between associated persons., 01.01.2007, RTL 2006, 81, 1506

3. Does accounting make the same type of distinctions as is evident in the plethora of legal arrangements for IP?
4. Which legal theory should be used when making monetary claims against the infringer: whether it is for compensation to the rightholder for the prejudice suffered or whether it represents the infringer's unjustified enrichment. No commercial scale requirement for claiming the compensation of damages in IP cases?

As result the author of the master's thesis will answer to the question: Do we really need the choice of the methods or valuation scale regulations provided by law, taking into account all the factors of influence on the valuation of intellectual property.

Method and Material.

A traditional dogmatic approach has been used in this Thesis. However, author has sought to strike a balance between presenting a purely academic argument and practical hands on experience. Sources of law derive from legal instruments, preparatory work and national case law. Due to the global spread of damage determination issues in European IP case law, procedures, laws and practice of United States as example of common law system, Germany as example of Civil law system, Finland as example of Scandinavian law system have been mentioned, analysed and subjected to comparison with the Estonian law.

In practice, there exists multiplicity of very different books for Intellectual property valuation, mostly of them are held in English and freely available in the library of The Estonian Intellectual Property and Technology Transfer Centre (part of WIPO library). All books are new and relevant for supporting any legal intellectual property research.

Further, the taxation issues, most not theoretical, but practical part of the Thesis based on an interview with the lecture of Tallinn University of Technology - Tax law expert Mr Marek Herm and Estonian Tax Board. Additionally, other sources of information include investigations, recommendations and guidelines of the European Union, U.S. and of other official bodies.

Disposition.

The structure and argumentation explained here and the master's thesis follows the consideration that the proceeding in the valuation can be structured in accordance with the valuation cause, thus the motive or the motivation of the valuation. Thus from a simple list or accumulation of empirically well-known causes develops a structure in accordance with which the further steps can be systematically derived. Therefore, the argumentation follows the approaches of Russel/Parr as well as Sykes/King.[5]

The goal of this, with the respect to the possible decision in practise, simplified structure of the master's thesis is to give the possibility of a structured overview of the complex and occasionally confusing interaction of the different influences, in particular legal factors and components that influence an intellectual property valuation.

In some cases, experts and lawmakers intentionally raise the value of goods and decrease competition by regulations protected of intellectual property, which indirectly creates obstacles to the new entrants to the market. The author argues that the results of intellectual property valuation illustrate the level of IPR protection. Thus, the value of IP is a link between the level of IPR protection and competition law rules.

With the goal of structuring, it also becomes clear as to why distinction is made here between legal and economic intellectual property valuation. The value of intellectual property in principle cannot be derived from purely legal consideration. The author follows the argumentation of A.Wurzer, that the legal characteristics are substantial determinants of the intellectual property value.[6]

There are the legal factors of influence presented here, which is actually of great systematic importance: Legal obligations for valuation. Examples: transfer pricing, external accounting, taxation, value determination in litigation, estimate of damages.

With the cause of valuation and its legal factors the author of the master's thesis presents the classification of the legal factors of influence for valuation intellectual property based on three groups of legal causes. They are the causes under transfer based cause, conflict based cause and financing based cause.

Chapter 1 deals with illuminating the transfer based causes and tools of valuation: valuation methods, due diligence, licensing, enterprise and asset transactions, transfer price determination, access to technology platforms.

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[5] Smith, Parr,. Valuation of Intellectual Property and Intangible Assets, 3rd ed. 2000

Sykes, King,. Valuation and Exploitation of Intellectual property and Intangible Assets, 2003

[6] Alexander Wurzer, Valuation of patents. Wolters Kluwer Law & Business, 2012, p 269

Chapter 2 introduces to the financing based cause: taxation, accounting, sales and price assignment, debt financing and equity financing.

Chapter 3 is about the conflict based causes: determination of damages and international court practice.

Author would like to thank Mr Pawan Kumar Dutt for his suggestions and commitment to this research. Author would also thank Mr Addi Rull for support upon the research. Also, author is very grateful to Mr Marek Herm for giving guides in tax issues. Thanks to The Estonian Intellectual property and Technology Transfer Centre for giving the opportunity to use the books. And last but not least, author would like to thank the members of the Defence Committee.

A. Methods of valuation and transfer based factors

I. Basic Valuation Approaches

The fundamental intangible asset valuation topics are presented in this Part of Master's Thesis. First, the author presents a general introduction to the three approaches to intangible asset valuation. Second, author summarizes the general theoretical concepts and practical applications of the three fundamental approaches to intangible asset valuation. Third, author outlines the general procedures regarding the preparation of the valuation synthesis and conclusion.

There are numerous methods and procedures that may be appropriate to the legal analysis and appraisal of intangible asset and intellectual properties. However, when analysts consider the fundamental similarities and differences among these numerous methods and procedures, they all logically group together into the three general categories of valuation analysis. These three fundamental ways of analysing of intangible asset are often called the cost approach, the market approach, and the income approach.[7]

An IP valuation should consist of the following steps:

1) Confirmation of the purpose and scope of the valuation.
2) Definition of the subject asset.
3) Identification of the premise, or basis, of value.
4) Selection of the appropriate valuation approach.
5) Selection of the method of valuation.
6) Determination of the valuation assumptions.
7) Cross check of the finders

The level of detail and rigour required in a valuation ranges between an indicative valuation and a formal valuation opinion. It is important to match deliverables with the purpose of the valuation. It is inappropriate to commission an indicative valuation for the purpose of litigation, financial reporting or transfer pricing, but in other instances management only needs to know the

[7] Reilly, R., Valuing intangible assets, Boston : McGraw-Hill, 1999 p. 96

order of magnitude of an asset's value in order to make a commercial decision. Valuation reports must always indicate whether there is a limitation of scope.[8]

A clear definition of the subject asset is especially important for IPR as terms such as 'technology' and 'brand' are subject to different interpretations. It is necessary to identify the specific rights that are bundled into a generic heading. The extent of rights within the package can have a significant impact on its earnings potential and value. The term 'technology' can include patents, patent applications, design rights, trade secrets, software and documented know-how. Similarly, there is no generally accepted definition of the term 'brand'. This is sometimes used in reference to trademarks and associated goodwill, while on other occasions it includes recipes, formulae, design rights and copyright. In extreme cases the term is used to describe a branded business unit, consisting of both tangible and IPR. When interactions between intellectual property rights are intense, they are treated as complimentary assets – both for transactional and valuation purposes.

Value is in the eye of the beholder, so it is essential to determine whether an asset is to be valued from the perspective of the current owner (value in use), a typical purchaser (market value), a specific purchaser (investment value), or an unwilling seller (liquidation value). The purpose of the valuation will usually determine the appropriate premise of value. In most commercial situations, market value is the appropriate premise. International Valuation Standards define market value as: "The estimated amount which a property should exchange on the date of valuation between a willing buyer and a willing seller in an arm's-length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently, and without compulsion."[9]

There are three valuation approaches, namely the cost approach, market approach, and the income approach.

[8] Liberman, A., Chrocziel, P., Levine, R., International Licensing and Technology Transfer: Practice and the Law, Wolters Kluwer Law & Business, 2011pp 18-19

[9] International Valuation Standards, Seventh Edition, 5.2, p. 27.

1. Cost Approach

The basic principles assert that an investor will pay no more for an investment than the cost to obtain an investment of equal utility. In other words, a willing buyer for an intangible asset will pay no more for the subject intangible asset than the price of an intangible property comparable utility. Accordingly, an efficient market adjusts the prices of all properties (including IPR) in equilibrium so that the price the market will pay is a function of the comparative utility of each property.

Knowledge of at least the future costs of creating IPRs is needed as part of almost all valuation methods. However, valuation methods based on the historic costs of acquisition perhaps less any allowances for depreciation or obsolescence are worth only the very briefest of comment. Their most serious failing is that they make no allowance for the future benefits which might accrue from the patent. They are of no help other than in historical cost based accounting systems or where taxation methods dictate their use and useless for making rational decisions.[10]

As the supply of substitute properties increase, ceteris paribus, market influences tend to drive down the cost of the substitute. As the supply of substitute properties decreases, market influence tends to drive up the cost of the substitute. Also value is not necessarily equal to cost, at least not to cost as measured in the historical accounting sense.

There is one application limitation with regard to the use of the cost approach to valuing intangible assets. Unlike fungible tangible assets, often there are no reasonable substitute properties to compare to many intangible assets and intellectual properties. Accordingly, with regard to the valuation of intangible assets with unique qualities, the cost approach may have application limitation.[11]

Within the cost approach to intangible asset valuation, there are several related analytical methods. Each group of analytical methods uses a similar definition of the type of cost that is relevant to the valuation. The most common types or definitions of cost are the following:

1) Reproduction cost.

[10] Pitkethly, R., The Valuation of Patents: A review of patent valuation methods with consideration of option based methods and the potential for further research, Oxford Intellectual Property Research Centre St.Peter’s College, Oxford, 1997

[11] Reilly, R., Valuing intangible assets, Boston : McGraw-Hill, 1999 p. 97

2) Replacement cost.

There are subtle but important differences in the definitions of these two types of cost.

Reproduction cost contemplates the construction of an exact replica of the subject intangible asset. Before appropriate adjustments are made for the purpose of deriving an indication of value reproduction cost does not consider either the market demand for or the market acceptance of the subject intangible. In other words, before the requisite valuation adjustments, the reproduction cost estimate does not answer the question of whether anyone would even want an exact replica of the subject intangible asset.[12]

Replacement cost contemplates the cost to recreate the utility of the subject intangible asset, but in form or appearance that may be quite different from an exact replica of the actual intangible property subject to appraisal. While the replacement intangible asset performs the same task as the subject intangible, the replacement asset may be better in some way than the subject.[13]

Unlike the reproduction cost concept, the replacement cost concept does consider the market demand and the market acceptance for the subject intangible asset, at least in part.

Basic theory indicates that cost alone typically does not provide a reasonable indication of value.

2. Market Approach

The market approach to intangible asset valuation is based upon the related principles of competition and equilibrium. These principles conclude that, in a free and unrestricted market, supply and demand factors will drive the price of any good to a point of equilibrium.

Value is often defined as expected price. Value is the price that property would expect to fetch in its appropriate marketplace. Value is not a cost, cost measures an historical price, not an

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[12] Mellen, C., Evan, F., Valuation for M&A: Building Value in Private Companies, John Wiley & Sons, 2010, p. 265

[13] Andriessen, D., Making Sense of Intellectual Capital: Designing a Method for the Valuation of Intangibles, Routledge, Oxford, 2004, p. 358

expected price. Price represents what one particular licensee actually paid to one particular licensor for the particular intellectual property.[14]

The aim of market based methods is to value assets by studying the prices of comparable assets which have been traded between parties at arm's length in an active market. Perhaps the most obvious case where the method might be said to work and the only case where the cost of an IPR is a possibly useful guide to its value is when the cost concerned is the price paid for the same IPR in a very recent comparable commercial transaction.

In other cases, comparability with other IP whose value is known from market transactions is the main problem. There is a risk that the comparisons made may not be justified and be no more than convenient measures of value. An important point is that the transaction used may relate to an IPR whose use may not represent the best use of the IPR to be valued (it could even be the same IPR that has not been used optimally of course). For an IPR to be exploited to the maximum extent possible requires 100% of the potential protected market for the underlying invention to be accessed. Some sale or licensing agreements may prevent this and values derived from them will be suboptimal.[15]

In all cases, market conditions influence what the expected sale or license price will be for an intangible asset, so market conditions influence what is value of an intangible asset is. Market conditions are influenced by the degree of competition in the marketplace and the availability of substitute goods in the market place. Accordingly, market influences directly affect the value – that is, the expected price – of an intangible asset.

The market approach uses two categories of analytical procedures to indicate value:

1) The collection and analysis of market-derived empirical transactions data; that is regarding the licensing of subject intangible asset itself and comparative intangible assets.
2) An assessment of the current market conditions and of the changes in market conditions between the dates of the empirical transactional data and the date of the analysis.

[14] Reilly, R., Valuing intangible assets, Boston : McGraw-Hill, 1999 p. 101

[15] Pitkethly, R., The Valuation of Patents: A review of patent valuation methods with consideration of option based methods and the potential for further research, Oxford Intellectual Property Research Centre St.Peter's College, Oxford, 1997

Market based valuation methods may also be based on comparable royalty rates. When deciding royalty rates there are of course numerous surveys which look at industry averages. Such averages are often used as a basis for setting royalty rates in licensing agreements or in establishing damages in litigation. However, these are likely to exclude rational consideration of virtually all factors other than the, albeit important, one of what people think is the "market rate". The risk is that for a particular IPR this may be a serious misvaluation and use of such average royalty rates may merely perpetuate sub-optimal decisions by a few leading companies throughout an industry.

However, whilst such a method may be a valid way of discovering the implicit market valuation of a IP, one cannot be sure that it provides an objective valuation. Furthermore there are few companies with only a single product. A more fundamental problem is that one is using a market valuation of the company as a basis for estimating the value of its IP and IPRs. One is thus making an assumption that the market is perfectly informed about the IPRs of the company and can calculate their value. If that is the case though, there is no reason why those who wish to calculate the value of the IPRs should not do the same calculations or have the same insights. If it is not the case, there is no reason why anyone should base their valuations on what is no more than a guess by others. This is especially so in the case of an internal valuation where the internal valuers should have more information than the external market.[16] It is often more difficult to collect and verify these external data as compared to internal data that are sometimes applicable to the cost and income approaches.

More importantly, however, it is often more difficult to apply these external data to the analysis of the intellectual property rights, because the data usually have to be arranged, analysed, selected, reanalysed, and adjusted before they can be applied to the valuation of the intellectual property rights. Nonetheless, the practical application of market approach method is a very complex and rigorous analytical process.

[16] Pitkethly, R., The Valuation of Patents: A review of patent valuation methods with consideration of option based methods and the potential for further research, Oxford Intellectual Property Research Centre St.Peter's College, Oxford, 1997

3. Income Approach

This is an approach sometimes used to estimate the value for intellectual property that has no predetermined statutory expiration (like trademarks) and for which net income (royalties or profit) is not expected to vary greatly over time, due to contractually defined license fees, for example.[17]

The income approach is based upon the principle of expectation. In this approach, the value of the intellectual property is the present value of the expected economic income to be earned from the ownership of that IPR. As the name of the principle implies, the investor anticipates the expected economic income to be earned from the investment in the subject intellectual property. This expectation of prospective economic income is converted to present worth – that is, the indicated value of the subject intellectual property.

Improvements on cost based methods of valuation include at least some forecast of future income from a patent and thus some appreciation of the value of the patent as opposed to just its estimated market price or its cost. This will inevitably also involve some element of forecasting the future cash flows. There are no doubt some who propose methods using projections of future cash flows to value patents without taking account of time or risk but such methods can be ignored.

The key issue in these methods is how the forecast cash flow is arrived at. It may be possible to identify and or forecast particular cash flows which are associated with a particular IPR through licensing or through direct exploitation. This may involve study of the costs of unpatented goods, of the return on capital of unpatented goods, of the return on assets of unpatented goods or of the price commanded by unpatented goods with the actual financial data for the IPR related business. Such methods are in some senses market based methods since they rely on market based averages. A further and very common method based on industry average royalty rates assumes that the income due to a patent per se is the royalty which would have to be paid by a licensee.[18]

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[17] Anson, W., IP valuation and management, Chicago : American Bar Association, 2007 p.64

[18] Pitkethly, R., The Valuation of Patents: A review of patent valuation methods with consideration of option based methods and the potential for further research, Oxford Intellectual Property Research Centre St.Peter’s College, Oxford, 1997

One notable use of income approach is found in the pharmaceutical industry, where a leading company is credited with applying a quick method when valuing marketed product lines for acquisitions.[19]

4. Concluding Comments

The final intellectual property value estimate conclusion is not derived simply by applying the technical and quantitative valuation procedures. Rather, it involves the application of the analyst's professional judgment and experience to the intellectual property valuation process.

The valuation of intellectual property has become an increasingly more integral and more complex part of the commercial and legal environment. Numerous generally accepted methods may be appropriate to the analysis and appraisal of intellectual property. Each of these methods may be grouped into the three basic IP valuation approaches.

Despite that the market approach ruled in the practice, also the income approach got reference. For example in Finish Supreme Court KKO:2011:92 decision was a mix of the market approach and the income approach. As the market prices were not directly usable in this case, the court determined the compensation for the infringement in a manner that reflected both the market approach and the income approach. The court put emphasis on the negotiation power of the parties and applied the hypothetical negotiation which is a recognized price setting method both in transfer pricing practice and in legal praxis of intellectual property. It means that the court sought to set the compensation as if the parties had negotiated it in wilful market situation and then split the compensation to the parties. Thereby, also the income approach got reference in the case law.[20]

Analysts typically use more than one valuation approach to analyse the subject of IPR. The IP value typically is based upon the analyst's professional judgment and experience, results in the conclusion of an overall value estimate for the IPR. This Part of Master's Thesis introduced the basic factors associated with the identification and valuation of IP.

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[19] Proctor, T., Strategic Marketing: An Introduction, Routledge, Oxford, 2013, p. 90

[20] Laine. A., Transfer pricing of intangible assets - Implications of Finnish intellectual property case law on valuation of intangible assets, Aalto University - Master's thesis, 2012

II. Transfer Pricing

As multinational enterprises proliferate, cross boarded transactions multiply accordingly. Particular attention to intellectual property transactions is appropriate because the transactions are often difficult to evaluate for tax purposes. Each these transactions are a potential income tax deduction in one nation and taxable in another. This commerce is certain to get the attention of tax collectors worldwide, and it has. This is a situation of interest in that the almost universal standard that is applied to compare a given transfer price to what it would be in an "arm's length" situation[21].

A key element in any price for goods or services is the payment for the use of assets employed by the seller. Many of those assets are intangible. The payment for their use is represented by an appropriate investment return on their value. An "arm's length" standard is defined in words almost identical to "fair market value". At the core of transfer pricing issues are the concept of value, intangible assets, intellectual property, and investment rates of return. That is why his subject is of interest.

The Part discusses the application of appropriate methods under the arm's length principle for establishing transfer pricing for transactions involving intellectual property used in commercial activities, including marketing activities. It also discusses specific difficulties that arise when the alleged infringer should use a low transfer price as evidence of the IP's invalidity, the lack of infringement, lower damages, the inappropriateness of injunctions, and inequitable behaviour. This Part explains how using the low transfer price in these ways is a natural extension of existing IP law and doctrine.

1. Legal basis

The Estonian Copyright Act Chapter VII "Use of Works" provides for regulation on transfer or licensing of author's rights. Many provisions regulated by the general Law of Obligation Act. The Act is based on the concept of contractual freedom and basically allows all substantial questions to be decided and agreed upon by the contractors.

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[21] Gordon, S., Valuation of intellectual property and intangible assets, New York : John Wiley & Sons, 1995, p 65

According to the fundamental provision, provided in paragraph 46 of Copyright Act, works shall be used by other persons only in case of transfer (assignment) of the author's economic rights by him or her, or on the basis of an authorization (license) granted by the author.

Rules applying to the form and content of copyright contracts can be found in paragraphs 48-52 of the Copyright Act. The legal definition of the author's contract is as follows: it is an agreement between the author or his/her legal successor and a person who wishes to use the work for the use of the work on the basis of which the author or his/her legal successor transfer the author's economic rights to the other party or grants to other party an authorization to use work to the extent and pursuant to the procedure prescribed by the conditions of the contract.

The Copyright Act provides some obligatory rules as to form of the author's contract. A general rule is stipulated, that an author's contract shall be entered into in writing.

Transfer of copyrights is also possible by succession. Copyright can also be transferred to the state. When author leaves no will and does not have heirs, according to general rules under the Law of Succession Act, the local government of the place for opening a succession is the intestate successor if there are no successors.

Proceeding from the Constitution of the Republic of Estonia, an author has inalienable rights to his/her creation. The state protects the rights of an author. In Estonia there is no special law regulating legal relations for inventions made under the direction of an employer. It is a problem for inventors who are working in factories and scientific institutes. The need for such law is obvious, because it would significantly improve the conditions of inventors working in such companies, and would increase the amount of domestic inventions and economic potential of Estonia.

According to Estonian Patent Act paragraph 43 a person entitled to apply for a patent, may transfer such a right to another person. The right to apply a patent shall also be transferred to the legal successor.

The owner of a patent may transfer a pending patent application or registered patent in the Estonian Patent Office to another person, transfer his/her rights to another person entirely or partially, give up the rights or pledge the patent. In the event of the death or the dissolution of the applicant or patentee if the person is a legal person, the pending application or registered patent shall transfer to the successor or legal successor. The Estonian Patent Office will be informed of the transfer by corresponding request accompanied by payment of the state fee and by document certifying the transfer or a an officially certified copy thereof if the request is submitted by a person to whom the patent application transfers.

One of the most common possibilities for the transfer of patent is the conclusion of a licensing agreement. A patentee (licensor) may transfer, in whole or in part, the rights of the patentee one or several persons (licensee) by a licensing agreement in writing. With the consent of a licensor, a licensee may transfer the rights conferred by the license to a third person by way of a sub-license. The term of the license shall be no longer than term of patent protection, upon supplementary protection of medical products and plant protection products it shall be no longer than the term of supplementary protection. Licenses may be registered in the Register but an unregistered license has no legal force with respect to third persons. Also in the case of collision of rights of several licensees with different license agreements, the advantage is held by the licensor whose license is registered in the Register. If a patent transfer to another person, the rights and obligations conferred by the license shall also transfer to the said person.[22] Trading in licenses plays a great role in the acceleration of technical progress, several licenses for Estonian inventions have also been sold abroad.[23]

According to the Estonian Trademark Act[24] paragraphs 4 and 61 registered trademark can be owned by natural or legal persons. A collective mark may belong to an association of persons with active legal capacity.

A trademark may be transferred in relation to all or some of the goods or services. A trademark shall transfer to the legal successor of the proprietor of the trademark, a trademark shall not be inherited by the state or a local government. The proprietor of a trademark may surrender the registered trademark to a natural or legal person in respect of all or some of the goods or services. A trademark cannot be surrendered if the trademark is encumbered with pledge, including in a bankruptcy estate or a licence has been issued or a prohibition of disposal has been made in relation to the trademark. The proprietor of a trademark may divide the registration into two or more registrations and divide the goods and services between these registrations.

[22] Kukrus, A., Tööstusomandi õiguskaitse, pp. 116-125

[23] Koitel, H., Innovatsiooni ja patendinduse roll rahvusvahelises majanduses, pp. 16-17

[24] Kaubamärgiseadus, RT I, 28.12.2011, 4

The proprietor of a trademark (licensor) may transfer the right to use the trademark to another person (licensee) pursuant to a licence agreement. The term of the licence shall not exceed the term of the trademark registration. An entry shall be made in the Register concerning a licence if a party to the licence agreement so request. Although the recordal of licence in the Register is not obligatory, non-recorded licence shall have no legal right with regard to a third person and licence agreement are recommended to be registered. Recorded licence agreement is of importance when requirement of usage of a trademark is under question – if the proprietor of a trademark grants a trademark licence to an interested person then the usage requirement shall be deemed to be completed with – use of the trademark with the consent of the proprietor of the trademark.

The owner of an industrial design may transfer (licensor) in whole or in part, the rights of the owner of an industrial design into the usufruct of one or more persons (licensee). With the consent of the licenser, the licensee may transfer the rights proceeding from the usufruct to a third person by a sub-licence. The term of the licence shall not exceed the term of the registration. It is not obligatory to record the licence in the Register, but a licence not registered in the Register shall have no legal right with regard a third person. Also, upon the collision of the rights transferred to several licensees by different licences, the prerogative shall belong to the licensee whose licence has been registered in the Register as provided in Estonian Industrial Design Protection Act paragraph 74.[25]

According to the Estonian Plant Variety Rights Act[26] paragraphs 41 and 42 the holder of a plant variety right may transfer the proprietary rights attached to the variety to another person who shall deemed to be the legal successor of the holder of the plant variety right with respect to the rights transferred. The rights of a holder of a plant variety right who is a natural person transfer to his or her successor. Legal successor and successors shall register transfers of rights and changes in shares in the plant variety rights register. Any act connected with the transfer of the right to apply for a plant variety right, transfer of the rights of a holder of a variety right or a change in shares is not binding on third persons or subject to performance before amendment of the entry in the plant variety rights register.

[25] Tööstusdisaini kaitse seadus, RT I, 12.07.2014, 147

[26] Taimekaitseseadus[1] , RT I, 04.12.2014, 10

Some countries have provisions whereby the rightholder can request the transfer of ownership of the infringing goods (or materials/implements that were used in the creation of the infringing goods), and such measures are not subject to a requirement that the infringer acted in bad faith. The value of these goods may not, however, exceed the actual prejudice suffered by the infringer.

In Estonia, reasonable expenses that will be incurred in the future due to the damage may be claimed as well as expenses related to the prevention or reduction of damage.

2. Arm's length principle

Arm's length principle can, however, be difficult to apply to controlled transactions involving intellectual property because such property may have a special character complicating the search for comparables and in some cases making value difficult to determine at the time of the transaction. Further, for wholly legitimate business reasons due to the relationship between them, associated enterprises might sometimes structure a transfer in a manner that independent enterprises would not contemplate.

Arm's length pricing for IP must take into account for the purposes of comparability the perspective of both the transferor of the property and the transferee. From the perspective of the transferor, the arm's length principle would examine the pricing at which a comparable independent enterprise would be willing to transfer the property. From the perspective of the transferee, a comparable independent enterprise may or may not be prepared to pay such a price, depending on the value and usefulness of the IP to the transferee in its business. The transferee will generally be prepared to pay this licence fee if the benefit it reasonably expects to secure from the use of the intangibles is satisfactory having regard to other options realistically available. Given that the licensee will have to undertake investments or otherwise incur expenditures to use the licence it has to be determined whether an independent enterprise would be prepared to pay a licence fee of the given amount considering the expected benefits from the additional investments and other expenditures likely to be incurred.[27]

This analysis is important to ensure that an associated enterprise is not required to pay an amount for the purchase or use of IP that is based on the highest or most productive use when the

[27] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, p.196

property is of more limited usefulness to the associated enterprise given its business operations and other relevant circumstances. In such a case, the usefulness of the property should be taken into account when determining comparability. This discussion highlights the importance of taking all the facts and circumstances into consideration when determining comparability of transactions.

The conditions for transferring IP may be those of an outright sale of the intangible or, more commonly, a royalty under a licensing arrangement for rights in respect of the intangible property. In some cases, intangible property will be bundled in a package contract including rights to patents, trademarks, trade secrets, and knowhow. For example, an enterprise may grant a licence in respect of all the industrial and IP it owns.[28]

In applying the arm's length principle to controlled transactions involving intellectual property, some special factors relevant to comparability between the controlled and uncontrolled transactions should be considered. These factors include the expected benefits from the IP (possibly determined through a net present value calculation). Other factors include: any limitations on the geographic area in which rights may be exercised; export restrictions on goods produced by virtue of any rights transferred; the exclusive or non-exclusive character of any rights transferred; the capital investment (to construct new plants or to buy special machines), the start-up expenses and the development work required in the market; the possibility of sub-licensing, the licensee's distribution network, and whether the licensee has the right to participate in further developments of the property by the licensor.[29]

When the intellectual property involved is a patent, the analysis of comparability should also take into account the nature of the patent (*e.g.* product or process patent) and the degree and duration of protection afforded under the patent laws of the relevant countries. Other factors for patents include the process of production for which the property is used, and the value that the process contributes to the final product. For example, where a patented invention covers only one component of a device, it could be inappropriate to calculate the royalty for the invention by reference to the selling price for the complete product. In such a case, a royalty based on a

[28] Cass, F., Computer Law & Practice: The Journal of Computer and Communications Law, 1987, p. 153

[29] Tax Analysts, Tax Notes International, University of Michigan, 2010, p. 1257

proportion of the selling price would have to take into account the relative value of the component to the other components of the product.[30]

In establishing arm’s length pricing in the case of a sale or license of IP, it is possible to use the CUP method where the same owner has transferred or licensed comparable IP under comparable circumstances to independent enterprises. The amount of consideration charged in comparable transactions between independent enterprises in the same industry can also be a guide, where this information is available, and a range of pricing may be appropriate. Offers to independent parties or genuine bids of competing licensees also may be taken into account.

In the sale of goods incorporating IP, it may also be possible to use the CUP or resale price method.

a. CUP method

The CUP method compares the price charged for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances. If there is any difference between the two prices, this may indicate that the conditions of the commercial and financial relations of the associated enterprises are not arm's length, and that the price in the uncontrolled transaction may need to be substituted for the price in the controlled transaction. The CUP method is the most direct and reliable way to apply the arm's length principle. Consequently, the CUP method is preferable over all other methods.[31]

It may be difficult to find a transaction between independent enterprises that is similar enough to a controlled transaction such that no differences have a material effect on price. Every effort should be made to adjust the data so that it may be used appropriately in a CUP method. Such data may be obtainable from commodity markets or may be deduced from dealer prices.

The CUP method is a particularly reliable method where an independent enterprise sells the same product as is sold between two associated enterprises. At the same time, the relevant market should be researched by analysing transactions in similar products to determine typical volume discounts.

[30] OECD.TP.Guidelines2010, supra at 158

[31] OECD.TP.Guidelines2010, supra at 63

b. Resale price method

The resale price method begins with the price at which a product that has been purchased from an associated enterprise is resold to an independent enterprise. This price (the resale price) is then reduced by an appropriate gross margin on this price (the "resale price margin") representing the amount out of which the reseller would seek to cover its selling and other operating expenses and, in the light of the functions performed (taking into account assets used and risks assumed), make an appropriate profit.[32]

The resale price margin of the reseller in the controlled transaction may be determined by reference to the resale price margin that the same reseller earns on items purchased and sold in comparable uncontrolled transactions ("internal comparable"). The determination of the resale price margin should take into account whether the broker is acting as an agent or a principal.

In making comparisons for purposes of the resale price method, fewer adjustments are normally needed to account for product differences than under the CUP method, because minor product differences are less likely to have as material an effect on profit margins as they do on price.

Where uncontrolled and controlled transactions are comparable in all characteristics other than the product itself, the resale price method might produce a more reliable measure of arm's length conditions than the CUP method, unless reasonably accurate adjustments could be made to account for differences in the products transferred.

The resale price margin requires particular care is where the reseller contributes substantially to the creation or maintenance of IP associated with the product (*e.g.* trademarks or trade names) which are owned by an associated enterprise. In such cases, the contribution of the goods originally transferred to the value of the final product cannot be easily evaluated.

3. Litigation

IP litigation – whether it involves patents, copyrights, or trademarks – typically follows a common lifecycle. The IP owner brings a suit against the alleged infringer. The alleged infringer defends by arguing that it does not infringe the IP, and also by countersuing that the IP is invalid

[32] OECD.TP.Guidelines2010, supra at 70

and hence unenforceable. The IP owner also often asks for preliminary injunctions against further infringement while the case progresses. If the IP is ultimately found valid and infringed, then the infringer is subject to remedies including damages and potentially a permanent injunction against further infringement. But these remedies can, in certain circumstances, be withheld by the court if the IP owner engaged in inequitable conduct.[33]

Transfer prices for IP and the contemporaneous expert documentation justifying the pricing are discoverable. Attorneys representing IP defendants should obtain discovery of both the transfer prices and the expert documentation. A transfer price has real legal significance. Enforceable rights were actually transferred by binding contract for that price. The companies hired experts to justify the price.[34]

Royalty rates are negotiated between the IP owner and licensees largely based on factors such as the IP's likelihood of validity, its scope, the damages it could generate, and the likelihood of an injunction shutting down the licensee's business.[35]

The proposals in this Part would not substantially undermine IP rights. For example, one might expect that a low transfer price for a patent would reduce its likelihood of being found valid from 80% to 75%, which is a genuine deterrent for IP-based tax avoidance but hardly undermines IP rights.

4. Invalidity

Jeffrey Matsuura observes that one of the "key components of effective valuation of legal rights of ownership for intangible assets… are the enforceability of the ownership rights."[36] In other words, the more likely IP is to survive a challenge to its validity, the more it is worth.

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[33] Blair-Stanek, A., Intellectual Property Law Solutions to Tax Avoidance, University of Maryland Francis King Carey School of Law, June 4 2014

[34] Awodiran, M., Transfer Pricing: A Tax Avoidance Tool of Multinational Corporations, Afe Babalola University, 2014

[35] Heberden, T., International Licensing and Technology Transfer: Practice and the Law, Wolters Kluwer Law & Business, 2011, p.9

[36] Matsuura, J., An Overview of Intellectual Property and Intangible Asset Valuation Models, RES. MGMT. REV., Spring 2004, pp. 33, 38

Conversely, the less likely the IP is to be held valid, the less it is worth. A reasonable explanation for a low valuation for IP is that it is likely invalid. As this Section demonstrates, existing doctrines in patent law and trademark law specifically make low valuation evidence probative of invalidity.

a. Patents

The most important[37] requirement for patent validity is "nonobviousness." Specifically, before the patent application was filed, the invention must not have been "obvious" to scientists or engineers having ordinary skill in the relevant field. This standard is imprecise and no patent can be 100% guaranteed to be valid. In virtually all patent litigation, the defendant counterclaims that the patent was obvious and hence invalid,[38] and courts find nearly half of litigated patents invalid.

Transfer-pricing valuations go to the heart of the nonobviousness inquiry. Obviousness is determined by whether the invention was obvious to persons having ordinary skill in the relevant field. The Company has the best information about the invention. A low transfer price is an admission, by the entity in the best position to evaluate the invention, that it was not a significant advance.[39]

Moreover, transfer-pricing valuation happens at the ideal time. Nonobviousness is measured at the time right before the filing date of the patent. Courts must evaluate obviousness as of this date, without later-occurring facts clouding the analysis. Multinationals tend to transfer patent rights very soon after the invention occurs, so transfer-pricing valuation is done close in time to the timeframe for evaluating nonobviousness. This timing is ideal.[40]

Transfer-pricing valuations are better evidence on nonobviousness. If a patent holder experiences commercial success with the invention, courts view that success as evidence that the patent was

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[37] Michael Abramowicz & John F. Duffy, The Inducement Standard of Patentability, YALE L.J. 2011 pp.1590, 1593

[38] Allison, J., Lemley, M., Empirical Evidence on the Validity of Litigated Patents, AIPLA Q.J. 1998, pp. 185, 208

[39] Blair-Stanek, A., supra at 18

[40] Mcnelis, J., New Designs: Licenses May Be Evidence of the Nonobviousness of an Invention, Fenwick & West, 1998

nonobvious, under the theory that if an invention is both obvious and lucrative, why wasn't it thought of earlier?

The commercial success of a product embodying a claimed invention is often used as evidence of nonobviousness. The courts suggest that evidence of commercial success is relevant to the question of obviousness because competitors would have been economically motivated to make the invention before the inventor if the invention had been obvious. Minnesota Mining & Manufacturing Co. v. Research Medical Inc., 679 F. Supp. 1037, 1054 (D. Utah 1988). The courts proffer that if the commercial success is based upon the capturing of a large market share or upon the licensing of the invention to many competitors, such actions tend to support the finding that the claimed invention is superior to existing products and is therefore a nonobvious advance over the prior art. Tennant Co. v. Hako Minuteman, Inc., 22 USPQ2d 1161, 1177 (N.D. Ill. 1991). Evidence of commercial success includes a showing of growth in market share, a decrease in market share after other companies begin infringing, and licensing to other companies.[41]

Commercial success can result from effective advertising, good distribution networks, unpatented features, or superior quality control, none of which reflect on the invention's nonobviousness. By contrast, the transfer-pricing valuation is unperturbed by such external factors.

Of course, a desire to avoid taxes may exert a downwards influence on transfer prices. A Company should be held to its transfer price, particularly when every other characteristic of transfer pricing indicates that it provides excellent data regarding obviousness.

Not only are transfer prices better evidence than commercial success, but a low transfer price should refute a patent holder's attempt to show nonobviousness through commercial success. A low transfer price proves that even after the development the multinational saw little potential commercial success from the invention. Thus, a low transfer price severs the logical connection between commercial success and nonobviousness.[42]

Transfer-pricing valuations are also better evidence than licensing success, which is another often-used secondary consideration, and which is based on the theory that those who would

[41] Mcnelis, J., supra at 2
[42] Mcnelis, J., supra at 3

license a patent know the field and would not pay money for a license unless convinced of the patent's nonobviousness.

But licensing success can be distorted by many external factors. For example, licensees often take out licenses simply to avoid the substantial expense and uncertainty of patent litigation, even for very questionable patents. Potential licensees may simply lack full information about how well the patented invention works. Mistrust and negotiation costs often keep patent owners from licensing to direct competitors. Licensees of patented technology are often more interested in accessing the unpatented know-how and trade secrets that also come in the licensing arrangement.[43]

b. Trademarks

Low transfer prices for a descriptive trademark are evidence that the trademark is invalid. Descriptive trademarks are those that describe some aspect of the product. Descriptive trademarks are valid only if consumers associate the mark with the mark's owner. Wide variety of evidence for determining whether or not secondary meaning exists. Examples include consumer surveys, amounts spent on advertising, the length and exclusivity of the mark's use, the mark's place in the market, number of customers, and sales data. Secondary meaning attaches only when "the public has learned to identify the name of the product with its source", said court in case Black & Decker Corp. v. Dunsford, 944 F.Supp. 220 (S.D.N.Y. 1996).[44]

A transfer price provides concrete, quantitative evidence of secondary meaning, or the lack thereof. Valuation closely relates to many of the long-accepted types of proof: A trademark's value reflects the place it gives its owner in the market, the number of customers who are accustomed to buying the trademarked products, and the sales volume of trademarked products.[45]

A trademark's value derives from its ability to increase its owner's profits either by increasing sales, by allowing charging a higher price, or both. Thus, a low valuation demonstrates that the

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[43] Caves, R., The Imperfect Market for Technology Licenses, Oxfrord bull, 1983 pp. 249, 260-62.

[44] Berger, T., Halligan, M., Trademark Surveys: A Litigator's Guide, OUP USA, 2011 p. 153

[45] Reilly, Schweihs, R., Valuation of Trademarks and Trade Names, J. Pension Plan and Compiliance, Winter 2000, pp. 35, 37-38

trademark either does not help increase sales (indicating little consumer awareness) or does not allow charging a higher price.

A low transfer price for a relatively new trademark is less damning than a low transfer price for the patent rights on a new invention. Patent nonobviousness is determined as of before the time of filing, so a low transfer price just after invention is particularly weighty evidence of obviousness and hence invalidity. By contrast, trademark secondary meaning is generally determined at the time the defendant started infringement, which may come many years after a low-price transfer. Between the transfer and infringement, secondary meaning could come into existence, supporting validity despite the low transfer price. Years may run between the transfer and the start of infringement.

Low transfer price for IP naturally indicates that it has a narrow scope. Unlike real property, which typically has clear scope defined by the land's physical boundaries, IP affords its owner a much more amorphous scope of protection against intrusion. In patent suits, a defendant can infringe the patent either literally or under the "doctrine of equivalents" that prevents defendants from avoiding literal infringement through minor changes. Trademark infringement suits require determining the "strength" of the mark, while trademark dilution suits require determining whether the mark is "famous." And in copyright law, the court must determine whether the defendant has engaged in "fair use." [46]

The mark's "strength" is crucial to determining whether the defendant is infringing. Strength is determined by looking at both its distinctiveness and its commercial strength, meaning its recognition in the marketplace. The stronger a mark is, the wider a scope of protection it receives, meaning that more names and symbols used by competitors can constitute actionable infringement.[47]

A low transfer price for a mark indicates the mark's low commercial strength, which means that the mark is weak and its scope should be narrower. In short, a trademark plaintiff's low transfer price is evidence making it harder to show infringement.

[46] Blair-Stanek, A., supra at 22

[47] Greene, T., Wilkerson, J., Understanding trademark strength, Stanford Technology law review, vol. 16, nr 3 spring 2013, pp. 543-554

Transfer pricing is also relevant to trademark scope in another way, as evidence of how much of the consuming public recognizes the trademark, and hence whether the trademark is sufficiently "famous" to be "diluted." Dilution is an entirely separate cause of action from infringement. Dilution can be an extraordinarily powerful legal tool for trademark owners – but only if the trademark is "famous." Famousness is a "yes/no" proposition: either a mark is famous and gives its owner a dilution cause of action; or it is not famous and gets zero protection against dilution.[48]

The statutory standard for famousness is whether the mark is "recognized by the majority of the potential consumers of goods analogous to the goods or services to which the trade mark applies."[49]

A low transfer price for a mark is evidence that few members of the consuming public actually recognize it and that the mark is not "famous." Each consumer who recognizes a mark provides some quantum of expected future profits. The value of the mark is, at a minimum that per-consumer value multiplied by the number of consumers who recognize it. Moreover, the expert report justifying the low transfer price for a mark will often contain damaging data and assumptions about low consumer recognition.

Additionally, a low transfer price suggests that a mark is not "famous," because of another statutory factor in the famousness determination: the duration and extent of the use and promotion of the mark and geographical area of the use of the mark, according to paragraph 7(3)(2) of Estonian Trade Marks Act. A low transfer price for a trademark means one of two situations exists. One possibility is that the total amount spent on advertising for the mark is correspondingly low, which makes this factor weigh against famousness. The other possibility is that the owner has spent more than that amount on advertising, but that its advertising has failed to get traction, which also weighs against famousness.

In sum, the low transfer price should be evidence weighing against famousness. Companies, which are disproportionately likely to have famous marks, will thus risk losing dilution remedies if they transfer trademarks for artificially low prices.

[48] Greene, T., Wilkerson, J., supra at 543-554

[49] Trade Marks Act[1], RT I 2002, 49, 308

c. Copyrights

Copyright's "fair use" doctrine is a defence against copyright infringement and plays a crucial role in limiting the scope of copying that gives rise to liability. In case Dellar v. Samuel Goldwyn, Inc. the court first developed the doctrine to justify uses of printed material that copyright statutes might otherwise have forbidden. English courts developed the fair use doctrine in the eighteenth and early nineteenth centuries, in cases decided under Great Britain's copyright statute.[50]

The factors that courts should consider in fair use determinations: In short, we must often, in deciding questions of this sort, look to the nature and objects of the selections made, the quantity and value of the materials used, and the degree in which the use may prejudice the sale, or diminish the profits, or supersede the objects, of the original work.

The statute governing fair use provides merely a nonexclusive list of activities that may be fair use (criticism, comment, news reporting, teaching, scholarship, and research), and provides four nonexclusive factors for courts to consider. One of these four statutory factors is the effect of the use upon the potential market for or value of the copyrighted work.[51] Indeed, the statute expressly contemplates that the copyright's value will be relevant to fair use, requiring courts to consider the effect of the use upon the potential market for or value of the copyrighted work. Assuming fewer potential markets for a copyright helps justify a lower transfer price.

In short, a low transfer price and the expert report justifying it will often significantly help copyright defendants to demonstrate fair use and thus to prevail.

5. Concluding Comments

When valuation of intellectual property at the time of the transaction is highly uncertain, the question is raised how arm's length pricing should be determined. The question should be resolved, both by taxpayers and tax administrations, by reference to what independent enterprises would have done in comparable circumstances to take account of the valuation uncertainty in the pricing of the transaction.

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[50] Ellis, H., Fair Use of Unpublished Works: An Interim Report and a Modest Proposal, Washington University Law Review, 1991 p. 1231
[51] Dratler, J., McJohn, S., Cyberlaw Intellectual Property in the Digital Millennium, Loose Leaf, 2014

When tax administrations evaluate the pricing of a controlled transaction involving intangible property where valuation is highly uncertain at the outset, the arrangements that would have been made in comparable circumstances by independent enterprises should be followed. Thus, if independent enterprises would have fixed the pricing based upon a particular projection, the same approach should be used by the tax administration in evaluating the pricing. In such a case, the tax administration could, for example, inquire into whether the associated enterprises made adequate projections, taking into account all the developments that were reasonably foreseeable, without using hindsight.

According to this Master's Thesis author's request to the tax authority it is recognised that a tax administration may find it difficult, particularly in the case of an uncooperative taxpayer, to establish what profits were reasonably foreseeable at the time that the transaction was entered into. It is recognised that tax administrations may not be able to conduct an audit of a taxpayer's return until several years after it has been filed. In such a case, a tax administration would be entitled to adjust the amount of consideration with respect to all open years up to the time when the audit takes place, on the basis of the information that independent enterprises would have used in comparable circumstances to set the pricing.

Intellectual property may obtain value as a consequence of advertising and other promotional expenditures, which can be important to maintain the value of the trademark. However, it can be difficult to determine what these expenditures have contributed to the success of a product. For instance, it can be difficult to determine what advertising and marketing expenditures have contributed to the production or revenue, and to what degree. It is also possible that a new trademark or one newly introduced into a particular market may have no value or little value in that market and its value may change over the years as it makes an impression on the market (or perhaps loses its impact). The value and any changes will depend to an extent on how effectively the trademark is promoted in the particular market. The low transfer price should be evidence weighing against famousness of the trademark.

Transfer price valuation is better evidence on nonobviousness of the patent. And "nonobviousness" is the most important requirement for patent validity.

A transfer price has real legal significance. Transfer prices for IP and the contemporaneous expert documentation justifying the pricing are discoverable. Attorneys representing IP defendants should obtain discovery of both the transfer prices and the expert documentation.

B. Financing based factors

Most of the valuation “technology” relating to valuing these assets came about as a result of taxpayers` desire to maximize their benefits under the tax law. Even before that, early attempts to account to business transactions came face to face with the unique characteristics of intangible assets and their resistance to quantification.

I. Tax law issues

1. Ways of avoiding tax payment

This Part explains how companies use IP to avoid taxes on a staggering scale, relying in large part on norms of international tax enshrined in thousands of bilateral tax treaties. Also this part shows how to make money on the high price license. The Part then explores the magnitude of the problem and its harmful effects. It concludes by surveying the various tax-law solutions proposed by policymakers and scholars. The author finds two way of avoiding tax payment by using the IP rights, there are following:

1) High-Price License

Hypothetical Company make a contract concluded at a higher-licence price with domestic or foreign companies. This Company agree to contract, receive payment and claim refund of the tax from authority according to their high price.

2) Low-Price License

Hypothetical Company sells IP rights to another company less than their real value and avoid of tax payment.

The price of IP in contract is extremely imprecise and law regulations can lead to a wide possible range of acceptable prices. Valuing IP – particularly brand-new IP – is difficult and subjective. Each piece of IP is unique and its economic potential is difficult to predict. Estonia Law provides that the value and the price of IP should be market value on relevant market. No legal Act provides any regulations provide detailed econometric methods to estimate IP values.

2. High-Price License of the IP

Company has every incentive to choose a high sales price to maximize tax and get refund of payment from authority. According to paragraph 33(1) of Estonian Taxation Act[1] a taxable person has the right to the refund of the payment made to the tax authority which exceeds the amount prescribed by law or administrative legislation or an amount overpaid upon performance or set-off of a monetary obligation.[52] Member States shall also grant to every taxable person the right to a deduction or refund of the value added tax referred in so far as the goods and services are used for the purposes of transactions relating to the economic activities as referred to in Article 4 (2) of the Directive 77/388/EEC[53] carried out in another country, which would be eligible for deduction of tax if they had occurred in the territory of the country. It gives right to Company to get money from State for high price of IP in contract.

According to Directive 77/388/EEC[54] art 11(A): "In order to prevent tax evasion or avoidance, Member States may take measures to ensure that the taxable amount in respect of a supply of goods or services shall be the open market value. The option shall be applied only in respect of supplies of goods and services involving family or other close personal ties, management, ownership, membership, financial or legal ties as defined by the Member State. For these purposes legal ties may include the relationship between an employer and employee or the employee's family, or any other closely connected persons." The same provided in Directive 2006/112/EC[55] art 80.

For the Tax Board the transaction is not ostensible, it is a normal sales agreement. Transaction Form corresponds to the economic substance of the transaction. It fulfils requirements of hypothetical “arm’s-length” negotiation between willing, uncontrolled parties. The price

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[52] Estonian Taxation Act[1] , RT I 2002, 26, 150

[53] 6th VAT Directive 77/388/EEC, available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31977L0388:en:HTML , accessed January 28, 2015

[54] 6th VAT Directive 77/388/EEC, available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31977L0388:en:HTML , accessed January 28, 2015

[55] DIRECTIVE 2006/112/EC, available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2006:347:0001:0118:en:PDF ,accessed January 28, 2015

corresponds objectively to the relevant market value. The selling price is a matter of contractual agreement between the parties and may be either higher or lower than the market price particularly in brand-new IP price, it is difficult and subjective. The unreasonable pricing arrangement does not mean for Tax Board that this transaction is ostensible. In fact, of course this is ostensible transaction in meaning of paragraph 83(4) of Estonian Taxation Act[1] with purpose to increase the tax amount, which person has the right to the refund from the tax authority, but no evidence of it.

The Company must hire valuators (usually banks) to ascertain an "arm's-length" price for the transfer to another company, and to support that price with extensive contemporaneous documentation. Any outsider (including judges) will not be able to discern IP value. And no legal Act provides the methods of calculation. The Estonian Law of Obligation Act is based on the concept of contractual freedom and basically allows all substantial questions (price) to be decided and agreed upon by the contractors.

If contract has the higher IP price, the Company has right to higher tax amount refund from Tax Board. And no legal Act provides any regulations which provide detailed econometric methods to estimate IP values/price. Unreasonable price or high price don't make the transaction ostensible don't make the basis for applying the paragraph 83(4) of Estonian Taxation Act[1].

The purchaser may obtain a tax advantage if the sales price exceeds the market value of the goods, because the higher price allows for a larger amount of input. This position is contrary to the VAT accounting principles, as appropriate, between the turnover of the undertakings given no substantive tax burden on both sides.

The Administrative Chamber of the Supreme Court of 25 April 2013 in case no 3-3-1-71-12[56] recognizes that under normal circumstances there is no need to adjust the transaction value of the good or service, unless the purchaser has full right of deduction. Increasing the value of the transaction would increase to the State obligation to the seller on the one hand, and, on the other hand increased to the same extent and the purchaser is entitled to deduct input VAT. In summary, the State could not deal with the adjustment of the value of additional income (see also

[56] Administrative Chamber of the Supreme Court, 25 April 2013, case no 3-3-1-71-12

the Administrative Chamber of the Supreme Court of 30 May 2007 in case no 3-3-1-22-07, p 12)[57].

3. Case no 3-11-261/147

This case is only on in Estonian court practise which deals with IP valuation issues and shows how the high-price of IP can be purpose of tax fraud.[58]

The Norber Grupp OÜ rented office space in the office building at Rävala pst 4 under the rent agreement between Norber Grupp OÜ and Legandijuhtimese AS. The Legendijuhtimise AS was operated under the CitySpa trademark of all these office spaces. The Norber Grupp ended the current agreement, considering that the Legendijuhtimise AS has breached its obligations. The dispute between the parties resolved the Harju Country Court in civil case 2-09-54884, the parties signed a juridical compromise agreement.[59]

According to the juridical compromise agreement the Norber Grupp organized the public auction to sall the CitySpa trademark and property owned by Legendijuhtimise AS. The Tsentraal SK OÜ made a written offer with price of 24 000 000 kroons (1 533 880 euro) for CitySpa trademark. The Norber Grupp used its pre-emptive right and bought CitySpa trademark for this price, the VAT is 4 000 000 kroons.

The Legendijuhtimise AS and Norber Grupp signed a contract of sale. The claim to pay the purchase price for CitySpa trademark for the Legendijuhtimise AS was offset by Norber Group financial claim to the Legenfijuhtimise AS in the amount of 26 696 480 kroons.

The Norber Grupp declared the VAT on the purchase price in amount of 4 000 000 kroons in its input VAT and submitted the application of claim of refund to the Tax Board with the result of tax overpayment in amount of 3 787 512 kroons. The tax authority established that the transfer price was artificially high. The tax authority established that the sale transaction was only with purpose of increasing the deductible input VAT of Norber Grupp.

The sales contract corresponds the objective transfer price of this trademark market value according to the position of Norber Grupp. Transfer price is an agreement between the contract

[57] Administrative Chamber of the Supreme Court, 30 May 2007, case no 3-3-1-22-07

[58] Tallinn Circuit Court, 25 November 2014, case no 3-11-261/147

[59] Harju Country Court, 05 April 2010, case no 2-09-54884

parties and it may be higher than the market price and as well lower. The high transfer price does not mean for Tax Board that this transaction is ostensible and does not affect the tax records.

The tax authority has not assigned any value for the CitySpa trademark. The complainant considers that the CitySpa trademark has a high monetary value. CitySpa has legal and economic characteristics of the trade mark, which has a law protection. Trademark and www.cityspa.ee domain is well known and consumers associate them with CitySpa location in this office spaces. This is confirmed by the Patent Office and the courts, as well as experts and the transfer price of trademark is a result of public auction.

The Norber Grupp believes that the CitySpa trademark value corresponds to the transfer price. The Norber Grupp submitted to the court as the proves of trademark value the answers to questions from Age Reklaam, opinion of Marju Liivand and opinion of Fysioline Eesti OÜ. The court decides that this not prove of the trademark value, because in listed opinions is not reference to the methodology of calculating the value of CitySpa trademark. About what may be evidence and proof of the IP value the author tells in detail based on the experience of the main EU states in Part C of this Master's Thesis.

The position of the tax authority was supported by patent attorney Villu Pavelts opinion that if the trademark is not registered, it cannot also be a subject of legal protection and this trademark can be freely used by all who want it.

Tax authorities submitted also to the court by the tax authorities ordered the assessment of the trademark CitySpa value from the audit firm BDO Advisory. BDO Advisory calculated the trademark fair value through the rental agreement letting revenues and used the discount cash flow (DCF) method. BDO Advisory explained selected calculation method and analysed why other possible method to can't be used in this case. Court does not suspect that the selected method is suitable for the trademark valuation. Lowering the value of a trademark is that there was also a risk that the trademark is not registered.

BDO Advisory assessment indicates that for trademark value calculation was used discounted cash flow method. In this context, explained: "Frome the first registration operation in this space the spa operation was the main business. The company's net assets, operating profit and net flows were with negative results. Valuable (in excess of operating cost of free cash flow generation) trademark for the negative results of operations cannot arise a problem." BDO Advisory assessment is included advice to the court not use the concessions of the value in calculation process and implement, as did the BDO Advisory, only information about equity of the company, which was negative.

Consequently, the court shall deem the BDO Advisory established a reliable and objective assessment. Unfortunately, this Master’s Thesis author got a rejection to a request to provide this assessment made by BDO Advisory for the tax authority. Due to this reason, the author cannot analyse the selection of this method for the IP valuation and BDO Advisory arguments. In author’s opinion this method is part of income method and not so common as market method usually used in court practice. Because of only one method was submitted to the court, the court said that this method is reliable and objective.

This case shows that the legal basis for the choice of IP valuation method is extremely needed. The courts do not have any idea how to evaluate the IP and relies only on expert opinion, which is highly questionable because there is no alternative presented in this case for valuation method choice.

The Supreme Court said that in this case is exceptional situation because of the circumstances of transaction referring to the suspicion that the buyer has the purpose by this transaction to achieve a greater amount of deduction of input VAT. It was indeed the average of complex administrative matter, but the resolution of the dispute took place in a reasonable amount of time. Since 37.5% of the appeal is satisfied, the procedural part of the cost of justice in the same proportion. This Master’s Thesis author will shows in detail analyse of the procedural part of the cost in Part C.

4. Low-Price License of the IP - International experience

The basic objective in a transfer-pricing scheme is to shift a business organization’s income from higher-tax jurisdictions to a lower-tax jurisdiction. This shift is typically accomplished through a parent company’s subsidiaries. The introduction sketched out the simplest use of IP as a tax evasion tool for European companies, using one Company as a hypothetical example. This Section fills in the details. When Company’s somewhere in EU-based engineers develop a promising invention, Company owns the rights to all patents that can be obtained on the invention. According to the art. 60 of European Patent Convention the right to a European patent shall belong to the inventor or his successor in title. If the inventor is an employee, the right to a European patent shall be determined in accordance with the law of the State in which the employee is mainly employed.[60] Estonian Patent Act in paragraph 12 sets that where the invention has been made in the course of fulfilling a contractual or work assignment, the right to apply for a patent and to become a patentee shall belong to the author or to another person pursuant to the contract or contract of employment.[61] Corporate ownership of employee-created IP is common practice in contacts, usually looks like the employee obligation to assign all inventions to the employer.

This Company licenses all the patent rights to a subsidiary in a tax haven like Ireland. The license can be made economically equivalent to selling the patent by licensing it for less than the patent's full legal term, but greater than the technology's economic life. Licensing allows the future profits from the patents to accrue to the Irish subsidiary, while the legal ownership remains with Company itself in the country where it based, with its robust protection for IP owners.[62] This license is respected, since this Company and its Irish subsidiary are separate corporate entities, and IP can be freely licensed.

Tax law requires that Company receive "arm's-length" royalties from its Irish subsidiary for the patent license. The "arm's-length" price is defined as the price that would have been charged if this Company had instead been dealing with an unrelated party under the same circumstances. The "arm's-length" principle for cross-border transactions is deeply enmeshed in not only domestic tax law, but also the numerous bilateral tax treaties, including Ireland.[63] This Company must pay corporate tax of resident country of these "arm's-length" royalties, including royalties, which include payments for IP licensing, in gross income. Corporate tax rates table shows the rates of most significant countries for Estonia.

[60] European Patent Convention, EPC 1973

[61] Estonian Patent Act, RT I, 12.07.2014, 105

[62] Senate report on investigations,offshore profit shifting and the tax code, Sept. 20, 2012, available at http://www.hsgac.senate.gov/download/?id=7B9717AF-592F-48BE-815B-FD8D38A71663 , accessed January 28, 2015

[63] Eesti Vabariigi valitsuse ja Iiri valitsuse vaheline tulu- ja kapitali juurdekasvu maksuga topeltmaksustamise vältimise ning maksudest hoidumise tõkestamise lepingIncome (Tax Treaty, Estonia-Ireland), Art. 9(1)(b) and (2), RT II 1998, 33, 62

Table 1. Corporate tax rates table

Location	In year 2014
Germany	29.58%
Sweden	22%
Estonia	21%
Finland	20%
Switzerland	17.92%
Ireland	12.5%

Source: KPMG., Corporate tax rates table[64]

According to the corporate income tax system applied in Estonia, undistributed profits are not subject to tax. Instead, income tax at the rate of 21% is charged on gross dividends. However, tax is calculated as 21/79 of the net dividend. Thus a company not distributing profit is not obliged to pay income tax. Taxable expenses are subject to 21/79 corporate income tax as well. The corporate tax rate is reduced to 20% in 2015.

The corporate tax rate is 29.58% in Germany. The overall income tax rate for corporations includes corporate income tax at a rate of 15%, solidarity surcharge at a rate of 0.825% (5.5% of the corporate income tax), and local trade tax. The local trade tax generally varies between 7% and 17.15%, assuming a municipality multiplier (Hebesatz) ranging normally from 200% to 490% (the average multiplier for 2012 was 393%). The local trade tax is not deductible as a business expense.[65]

In Switzerland the maximum effective corporate income tax rates range from 11.48% to 24.43% depending on canton and commune. The rates comprise federal, cantonal, and communal taxes. All 26 cantons apply different tax rates and in most of them the statutory tax rate needs to be multiplied with the communal and/or cantonal coefficients that may vary from tax period to tax period. As all taxes including corporate income taxes are deductible when computing the tax basis, the effective corporate income tax rates are lower than the statutory rates published in the tax codes. The average of the maximum effective corporate income tax rates in the capital cities

[64] KPMG, Corporate tax rates table, http://www.kpmg.com/GLOBAL/EN/SERVICES/TAX/TAX-TOOLS-AND-RESOURCES/Pages/corporate-tax-rates-table.aspx , accessed January 28, 2015

[65] The Fiscal Code of Germany in the version promulgated on 1 October 2002 (Federal Law Gazette [Bundesgesetzblatt] I p. 3866; 2003 I p. 61), last amended by Article 13 of the Ordinance of 18 December 2013 (Federal Law Gazette I p. 4318)

of the cantons is 17.92%. Until 2012 the tax rate in the city of Zurich (currently 21.15%) was published in this survey as the main tax rate of Switzerland. However, it has been decided that the average tax rate applicable in the capital cites of the cantons is considered to be more meaningful. In 2014, the community of Meggen in the canton of Lucerne has the lowest corporate income tax rate (11.48%) while some communities in the canton of Geneva have the highest (24.43%). However, if a company qualifies for a holding, principal, or mixed company ruling, the effective tax rate can be reduced to a minimum of 5%. Additionally, full tax holidays up to 10 years might be available in some regions.

Finally in tax-haven like Ireland the corporate income tax rate is 12.5% for active income of new operations. A corporate income tax rate of 25% applies to passive income and income from certain land dealing activities, mining, and petroleum activities. Capital gains are taxed at 33% with a participation exemption for gains on disposals of certain shareholdings of 5% or more of companies resident in EU or income tax treaty states.

Our Company must hire valuators (oftentimes economists) to ascertain an "arm's-length" price for the transfer to Ireland, and to support that price with extensive contemporaneous documentation. But Company chooses and pays these valuators, who are inclined to err towards lower valuations. Valuations tend to agree with their paymasters on valuation questions.

After the transfer to Irish subsidiary, the patented technology is incorporated into a new device. Most of this increase in value reflects the artificially low earlier transfer price. But some of the increase in value results from the phenomenon that a well-designed patent portfolio (such as the one that a company assembles in Ireland) has more value than the sum of the value of its individual patents standing alone. The Irish subsidiary oversees a Chinese or India contract manufacturer's building of the new devices. The Irish subsidiary then sells the devices for a full mark-up that includes the value of the IP to our Company distribution subsidiaries worldwide, who then sell them to consumers. The substantial profits from the IP remain in Ireland, typically not subject to Irish tax, and not subject to for example German or Estonian tax as long as the cash is not returned to this countries.[66]

When our Company transferred the IP to its Irish subsidiary, a true "arm's-length" price would have been substantially higher, reflecting its potential for great profitability as part of the newest

[66] Blair-Stanek, A., supra 8

device – and resulting in correspondingly higher tax. The artificially low transfer price is what allowed the tax evasion.

5. Sale, Services, and Cost-Sharing Arrangements

Licensing and cost-sharing arrangements are the two most popular IP offshoring approaches. The licensing described above is one of the most popular of this[67] methods used by companies to transfer IP to subsidiaries in tax havens like Ireland for artificially low prices before the IP's high value becomes apparent.[68] But there are three other theoretical methods that companies can use.

First, the patent can be sold outright (rather than licensed) for an artificially low sales price to our Company's Irish subsidiary. It is possible to sell the IP for tax purposes to the Irish subsidiary while the legal title remains in Germany. Sales and licenses can be structured to have nearly identical economic consequences. Company has every incentive to choose a low sales price to minimize tax. The patent rights likely have zero basis, because R&D expenditures are immediately deductible.

Second, the IP rights can be bundled with a contract to provide both IP and related services for an artificially low price.[69] For example, Company could enter into a low-priced contract with its Irish subsidiary whereby our Company provides both rights to the IP and engineering services closely related to the IP.[70] Bundling with services obscures the value of the IP. Again, much of the profits from the IP end up with the Irish subsidiary, not subject to domestic tax.

Third, the IP rights can be contributed to a cost-sharing arrangement. For example, our Company and its Irish subsidiary might enter into a contractual cost-sharing arrangement to jointly co-develop IP. This Company would contribute IP developed by its German engineers, in return for an artificially low "buy-in" payment from the Irish subsidiary.[71] Irish subsidiary would then fund a share of this Company's Germany-based research to further develop the IP. This funding

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[67] Senate report on investigations,offshore profit shifting and the tax code, Sept. 20, 2012, available at http://www.hsgac.senate.gov/download/?id=7B9717AF-592F-48BE-815B-FD8D38A71663 , accessed January 28, 2015

[68] JCT REPORT, *supra* note 27, at 20-21; Graetz & Doud, *supra* note 4, at 396-98.

[69] JCT REPORT, *supra* note 27, at 20; Graetz & Doud, *supra* note 4, at 397.

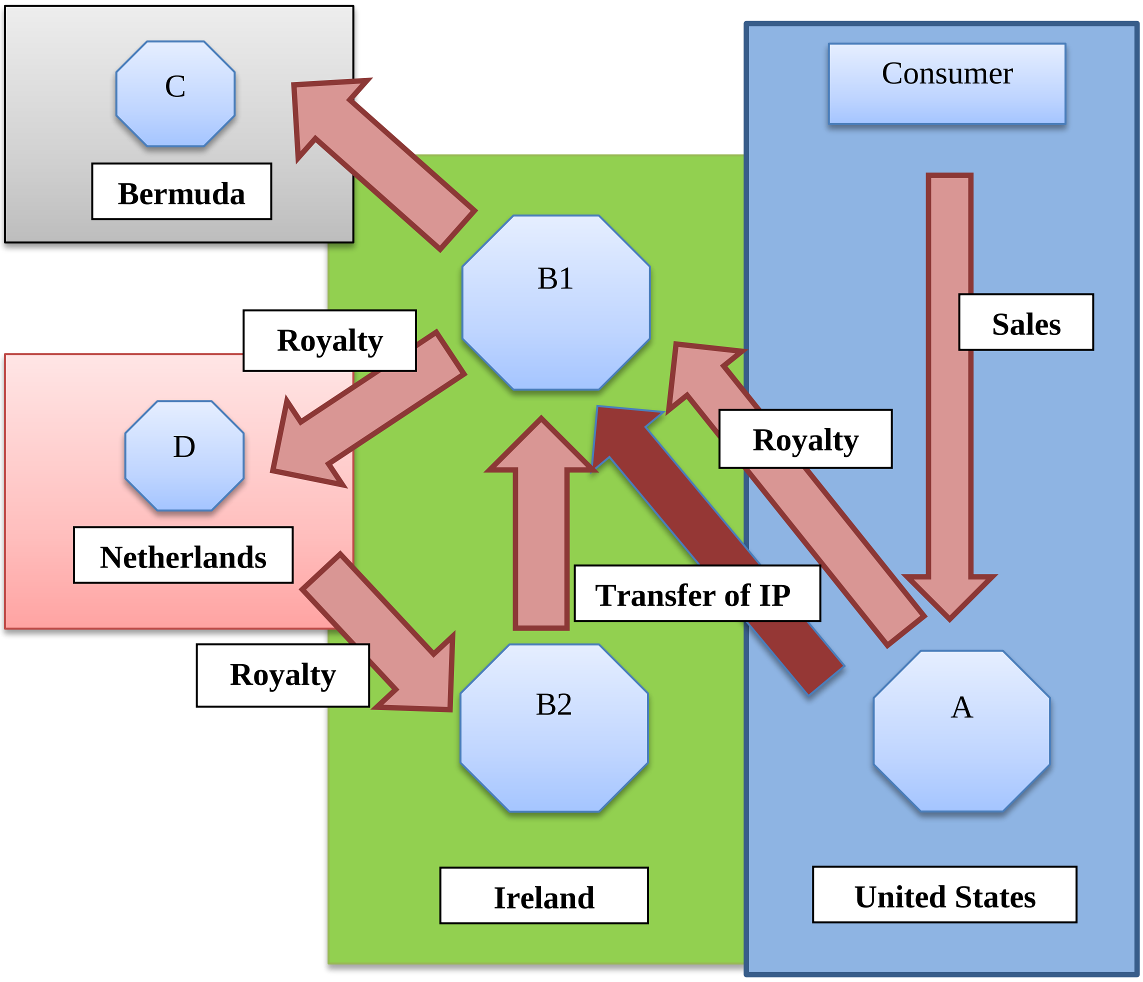
[70] JCT REPORT, *supra* note 27, at 57.

[71] Lee A. Sheppard, Intangibles Migration and Excess Profits, 130 TAX NOTES 1379, 1381 (2011)

would have no tax implications for this Company. But all rights to profits from the IP outside the Germany would be held by the Irish subsidiary, where the profits pile up tax-free.[72]

All strategies for using IP as a tax evasion tool have a common thread: setting an artificially low price for the IP at an early point, with the profits later accumulating in tax havens like Ireland. New York Time have detailed how corporations use creative IP transactions to avoid taxes and this scheme called "Double Irish Dutch Sandwich" and showed in figure 1.

Figure 1. Double Irish Dutch Sandwich (made by the author of this Thesis)



[72] Senate report on investigations, offshore profit shifting and the tax code, Sept. 20, 2012, available at http://www.hsgac.senate.gov/download/?id=7B9717AF-592F-48BE-815B-FD8D38A71663 , accessed January 28, 2015

Companies that transfer IP for artificially low prices are not engaging in tax fraud, which generally requires hiding information from the Tax Board or misleading the Tax Board. Indeed, companies pay for extensive expert documentation to back up low transfer prices and make it available to the Tax Board upon request according to paragraph 14[1] of Estonian Taxation Act[1].[73]

Ireland is hardly the only destination for IP; other popular destinations include the Netherlands, Singapore, and Switzerland.[74] Companies often even avoid paying the relatively low taxes in these countries. Ireland has a corporate tax rate of 12.5%, compared to the Germany corporate tax rate of 29,58% and Estonian 20%. But through structures with exotic names such as "Double Irish Dutch Sandwich" that rely on tax treaties and subsidiaries in traditional tax havens such as Bermuda and the Cayman Islands, companies often avoid even paying tax in countries like Ireland. But for all these varied tax evasion structures, the gateway is the artificially low price initially put on the IP.[75]

6. Concluding Comments

As the World Trade Organization (WTO) observes, "Many products that used to be traded as low-technology goods or commodities now contain a higher proportion of [IP] in their value — for example brand-named clothing or new varieties of plants."[76] Indeed, it is estimated that two-thirds of the value of large industrial companies now derives from intangible assets.[77]

Not only patents, but also trademarks and copyrights are transferred early to subsidiaries in tax havens for low prices. The copyright on the course code for unreleased software program or the trademark for a burgeoning product line might be transferred for an artificially low price.

Companies use IP-based approaches to avoid taxes to other countries, which has generated intense public anger in austerity-weary Europe.

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[73] Estonian Taxation Act[1], RT I 2002, 26, 150

[74] JCT REPORT, *supra* note 27.

[75] Charles Duhigg & David Kocieniewski, How Apple Sidesteps Billions in Taxes, N.Y. TIMES, Apr. 28

[76] World Trade Organization, Intellectual Property: Protection and Enforcement, http://www.wto.org/english/thewto_e/whatis_e/tif_e/agrm7_e.htm

[77] Menell, P., Scotchmer, S., Intellectual Property Law, in 2 Handbook of law and economics, A. Mitchell Polinsky & Steven Shavell, 2007, pp. 1473-1570

Tax law faces two fundamental roadblocks in countering companies' IP-based tax evasion strategies: information asymmetry, and international legal norms.

First, taxpayer inherently knows far more about the characteristics, potential, and value of its IP than does the Tax Board (or any valuator). For example, Apple understands how its new invention could fit profitably into a new smartphone in a way that neither a team of Tax Board experts, nor a team of private valuators, ever could.[78]

Taxpayers can fully comply with the law by disclosing all facts to their valuators who must determine the "arm's-length" transfer price. Any outsider (including judges) will not be able to discern its profit potential. But the companies can determine its profit potential, which materializes after the IP is safely in Ireland.

Second, the prevailing international tax law provisions in Europe date from work by the League of Nations in the 1920s. They are embodied in thousands of bilateral tax income tax treaties and in most countries' tax laws. They reflect the economic realities of the era where value was created through manufacturing interchangeable physical goods. Now that intangibles account for the bulk of the value of international commerce, these provisions are problematic.

The market value price is the most problematic provision, allowing IP transactions at easily manipulated prices. The other problematic international norm is respecting corporate subsidiaries as separate entities.

The leading international tax policymaker recently testified before the U.K. House of Lords that if adoption of new provision were not coordinated among the approximately 200 countries, the result could be double taxation and other tax chaos.[79]

This Part demonstrates that current weaknesses in the tax law's transfer pricing regulations are obvious. Ambiguities in accounting standard create the potential for companies to manage their earnings by avoiding reporting tax liabilities for foreign profits, thereby improving the appearance of their financial statements to shareholders and investors and this is detailed in the next Part.

[78] Blair-Stanek, A., supra at 13

[79] David D. Stewart, OECD and European Commission Leaders Discuss Fundamental Corporate Tax Reform, Wordkwide Tax Daily, June 12, 2013

II. Accounting issues

1. Background

The reason to begin with accounting principles is because many immediately turn to a company's financial statements as a source of asset value information. It is important to understand the assumptions underlying these statements in order to be able to separate the "wheat from the chaff" relative to data that is useful in the valuation process.[80]

Intangible assets and intellectual property are present in every business enterprise. Many of these, such as patents, trademarks, and copyrights, exist as a result of the operation of a complex body of law. The purpose of this master's thesis is to focus on those characteristics that affect their valuation.

"There is an unfortunate tension regarding modern intellectual property. On the one hand, intellectual property has never been of more importance to a wide range of actors, both public and private, within society. On the other hand, intellectual property has become more or less complex in its substance and regulation by the law. As a result there is a non-trivial 'knowledge gap' in significant sections of the community about intellectual property"[81].

The knowledge gap referred to above is a term that attempts to highlight the contestable nature of intangibles such as intellectual property (IP) and the rights attached to them. This Part demonstrates that this gap also exists between the economic framework of accounting, which attempts to recognise intangibles as assets, and legal frameworks that recognise intellectual property rights (IPR). This lack of consensus creates significant challenges for companies operating in a global environment. Accounting, as with the legal environment, has entered into the global arena through the introduction of an international suite of accounting standards for financial reporting in domestic regimes. Whilst legal regimes seek to define IP as an intangible with particular qualitative characteristics such as inventiveness and novelty, accounting regimes seek to measure and quantify according to the economic benefit that the intangible will accrue to an entity and subsequently capital providers.

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[80] Gordon, S., Valuation of intellectual property and intangible assets, New York : John Wiley & Sons, 1995, p 39

[81] Christie, A., Intellectual Property and Intangible Assets: A Legal Perspective, Intellectual Property Research Institute of Australia Occasional Paper, Intellectual Property Research Institute of Australia, University of Melbourne, No. 1/05, April 2005, p. 5

Financial accounting reports are said to provide information for users to make economic decisions, in particular decisions relating to investment. The information presented has implications for the allocation of scarce resources and is therefore subject to regulatory intervention in the form of accounting standards. These standards determine the measurement and disclosure requirements for the elements of financial statements. In accounting discourse IP and IP rights are recognised as intangible assets if they satisfy the criteria of the accounting standards. Representation in a company's balance sheet rests on the ability to measure and value according to the rules for recognition of an asset

In most 'western' industrialised nations, the accounting rules or standards have traditionally emerged from a national process of standard setting. In 2001, the internationalisation process was revitalised by the new International Accounting Standards Board (IASB) resulting in the promulgation of a suite of international accounting standards for financial reporting. The associated accounting rules and definitions are a political, institutional and social practice that are contested and not necessarily aligned with discourses embedded in other frameworks. Substantively creative or innovative knowledge derived from human endeavour is an intangible that may attract certain legal rights according to rules which govern those rights. In the attempt to measure and value intangibles, accounting frameworks have their own discourse of recognition and measurement and attach different meanings.

This Part begins with an overview of accounting and its role in society, followed by a discussion of intellectual property and the discourse of accounting. These themes are set in the context of the internationalisation of accounting standards, in particular IAS 38 *Intangible Assets*. The Part concludes with a discussion of the contrasting nature and challenges that emerge from global rules in relation to the recognition of IPR.

2. Context of Accounting

Although the modern form of double entry bookkeeping is largely credited to the work of a 15th century Franciscan monk, Luca Pacioli, financial accounting has existed in some form as far back as record keeping in ancient civilizations[82]. The traditional view of accounting taught in introductory courses at university is that the practice and role of financial accounting is to produce and communicate financial information for users to make economic decisions. Two

[82] Belkoui, A., Jones, S., Accounting Theory, Nelson Thomson learning, Melbourne 2nd Ed., 2002

broad streams of accounting are further identified according to the nature of these users of financial information. Management accounting provides information for the internal decision-makers of an organisation. Budgeting and product costing are examples of management accounting practices. The quality of this information is judged according to its relevance and timeliness for decision-making. Financial accounting, conversely, provides information for users external to the organisation. The stewardship function of providing information to investors or potential investors by managers highlights capital providers as a primary user group. It is generally accepted, however, that there are a diverse range of stakeholders, including creditors, employees, civil society, lobby groups and governments who use financial accounting information for a variety of purposes. For this reason the attributes of financial information of reliability, objectivity and comparability are paramount.

Financial accounting information is usually presented in the form of financial statements consisting of a statement presenting a calculation of the profit or loss over a specified period of time and a statement of financial position presenting the assets and liabilities of an organisation at a specified date. In addition a statement reporting the cash flows for a specified period may be included. Other accounting information of both a non-financial and financial nature is disclosed in notes or appendices to the financial statements. The financial statement information relies on monetary figures to represent a transaction or flow of resources. In other words, it is an abstraction for 'real world' events[83]. Reliance of users on the information provided for decision making results in the highly regulated environment for financial reporting. To ensure consistency of financial reporting, this regulation of accounting is most commonly found in accounting standards. In Australia, as in most jurisdictions, it is a mandatory requirement under company law[84] for preparers of financial reports to follow accounting standards promulgated by the national standard-setting authority. These standards basically prescribe the rules and procedures for the recognition, measurement and disclosure of financial and non-financial information in published financial reports. Recognition involves a system of criteria which define the elements of reports and include the answer to questions such as when does a transaction result in reporting of revenue; expenses; assets or liabilities. Measurement criteria govern how the elements are to be represented monetarily. Disclosure requirements mandate where this information is presented in the financial reports, or alternately disclosed in notes. These criteria are interdependent and intertwined. Measurement involves recognition and disclosure depends on measurement

[83] Gaffikin M J R, Principles of Accounting, Harcourt Brace, Sydney, 3rd Ed., 1994

[84] Corporations Act of Australia 2001, Act No. 50 of 2001, as amended up to Act No. 180 of 2012

characteristics. In this way, accounting makes visible certain social phenomenon and transactions, however in doing so, it obscures others[85].

Although the conventional view of accounting as a communication device is reinforced and legitimated in the regulatory environment in which financial accounting is located, there is a body of literature that focuses on the notion that accounting mediates social relationships and is said to be a social and institutional practice. From this perspective, accounting gives meaning to social elements and social transactions, so that the definition and understanding of an asset or profit is peculiar to accounting and reinforced through regulation[86]. Therefore, the social and institutional context of accounting and standard setting is important to consider.

3. The Internationalisation of Accounting Standards

To recognise that accounting is a social and institutional practice also means recognising diversity in social, cultural, political and economic contexts. This diversity is seen between the various forms of organisation which give account as well as the cultural milieu in which accounting takes place. In most western economies, the standard setting procedure for accounting has traditionally existed at a national level. In the last decade the accounting profession has witnessed a shift to global or international accounting standards presenting challenges for the recognition and measurement of intangibles, in particular, intellectual property.

While the economic environment that corporations operate in has developed quickly over recent years, the accounting community has lagged behind. In 1973, the International Accounting Standards Committee (IASC) was founded. Its primary objective was to develop a common international approach to accounting standard setting with a view to improve the principles underpinning the preparation of financial statements and global harmonisation of accounting standards.[87] Indeed, the current chairman of the international standard setting body, Sir David Tweedie sees the development and implementation of international accounting standards as

[85] Andrew J., The accounting craft and the environmental crisis: reconsidering environmental ethics, Accounting Forum, **24**(2) 2000, 197-222

[86] Miller P, Accounting as a social and institutional practice: an introduction, in Hopwood A G and Miller P (Eds), Accounting as a Social and Institutional Practice, Cambridge University Press, London, 1994, pp. 1-39

[87] Belkoui, A., Jones, S., Accounting Theory, Nelson Thomson learning, Melbourne, 2nd Ed., 2002

imperative to the effective functioning of global capital markets and "essential to our economic well-being".[88] In 2001, a revised committee, the International Accounting Standards Board (IASB), with a new constitution and structure, emerged as a more powerful force and effectively revitalised the effort for global harmonisation. By 2005, a suite of international standards were ready for adoption in national contexts. First adoptees included the European Union, Australia and New Zealand. Whilst each country may choose not to endorse all standards, or indeed any standard in its entirety, in substance local standards are virtually word-for-word International Financial Reporting Standards (IFRS)[89]. In 2006 more than 100 countries have committed to adopt International Financial Reporting Standards, with many more expected to commit to adopt by 2011.[90] The continuing process of international standard-setting is currently viewed as a collaboration between the IASB and the US-based Financial Accounting Standards Board (FASB) in an effort to harmonise US standards. The aim is to ensure consistency between companies domiciled in the world's largest financial market and other jurisdictions.

4. An International Standard for Intangible Assets IAS 38

In accounting, expenditure on items of an intellectual property nature can be recognised as an asset if certain criteria are met. Assets are defined as either tangible, having physical substance, or intangible. Intangible assets are further classified as identifiable or non-identifiable. Whilst intangible assets are dealt with in a number of accounting standards, for example the definition and measurement of 'goodwill'[91] is regulated by a standard dealing with business combinations (IFRS 3), IP generally falls within the ambit of the international accounting standard devoted entirely to intangible assets, IAS 38 *Intangible Assets*. It is from within this standard that we examine accounting for IP.

[88] Tweedie D, Testimony before the Committee on Banking, Housing and Urban Affairs of the United States Senate, Washington, September 9, 2004

[89] Deloitte Touche Tohmatsu, IFRS in Your Pocket 2005, 2005, p. 50

[90] Dzinkowski R, Let's Get Together, In the Black, February, 2006, pp. 54-56

[91] Under the IFRS schema there is no longer a separate standard for goodwill. In accounting discourse goodwill is defined in economic terms as the excess of the cost of the business combination over the net fair value of identifiable assets and liabilities. In essence it recognises the future economic benefits of assets that cannot be separately identified or recognised.

IAS 38 *Intangible Assets* has created significant changes in the way companies account for their intangibles. By their very nature intangibles are both difficult to define and measure. As companies increasingly have their value based on intangible assets, the issues surrounding definition and measurement have become increasingly important.[92] Therefore, the release of the IAS 38 in March 2004, which applies to the accounting for intangible assets for annual periods commencing on or after 31st March 2004,[93] was regarded as a watershed. "An asset is a resource that is controlled by the entity as a result of past events (for example, purchase or self-creation) and from which future economic benefits (inflows of cash or other assets) are expected."[94] An intangible asset is a non-monetary asset without physical substance. Examples of possible intangible assets include patents, copyright, goodwill, brand names and research and development. The critical attributes of an intangible asset according to this definition are:

- Identifiability
- Control (power to obtain benefits from the asset)
- Future economic benefits (revenues or reduction in costs)[95]
- The ability to measure reliably

IAS 38 distinguishes between internally generated intangibles and those which are purchased. Therefore, except in the special case of development costs, IP is recognised as an intangible asset only when it is the result of a commercial transaction. Whilst development expenditure is not generally separately identified as an IPR, there is some scope in legal regimes for the protection of certain information.

In particular, the TRIPS Agreement (Art. 39.3) protects undisclosed test data relating to pharmaceutical and agricultural chemical products in the development phase. In contrast to the general characteristics of creativity and innovation the rationale is based on the notion of "unfair commercial use".

[92] Deegan C, Australian Financial Accounting, McGraw-Hill, 2005

[93] Web Summaries: IAS 38: Intangible Assets

[94] IAS Plus, International Accounting Standards IAS 38, Intangible Assets, http://www.iasplus.com/standard/ias38.htm , accessed December 15, 2014

[95] IAS Plus, International Accounting Standards IAS 38, Intangible Assets, http://www.iasplus.com/standard/ias38.htm , accessed December 15, 2014

5. IP Right or Asset

A tangible asset can be possessed exclusively by physical security against access by third parties, exclusive possession of intangible assets is problematic. In order to solve this problem, the law, through the granting of intellectual property rights, provides a means of legal security.[96] Intellectual property rights refer to legal entitlements held by legal entities (individuals or companies) that are enforceable under law against other legal entities. Recognising that intellectual property rights can be 'owned' and have 'value' in the modern globalised economy necessitates accounting regimes where values are measured and reported and ownership acknowledged. However not all IPR are recognised as intangible assets and conversely some intangible assets which are considered IP are not recognised as IPR by law.

The inconsistencies demonstrated above arise from the differences in the underlying assumptions relating to 'intangibles' and the definitions of 'rights' and 'assets' according to the rules in legal and accounting discourses. The table below (Table 2) provides an overview of these contrasts.

Table 2: Contrasting Assumptions of IPR and Intangible Assets

	Legal discourse	**Accounting discourse**
Intangible	• Creativity • Innovation • Human endeavour	• Identifiable • Non-monetary • Without physical substance • Measured reliably
Rights	Exclusivity related to: • Subject matter and specific legal regime e.g. copyright • Satisfies threshold on creativity and innovation • Limited duration • Transferability	Asset definition based on: • purchased not internally generated • future economic benefit • entity can control its use • past transaction
Rules	• International Treaties e.g. TRIPS • Legislation • Common law • Equity	• International Accounting Standards • National accounting standards • Generally accepted accounting principles (GAAP)

96 Christie A, Intellectual Property and Intangible Assets: A Legal Perspective, Intellectual Property Research Institute of Australia Occasional Paper, Intellectual Property Research Institute of Australia, University of Melbourne, No. 1/05, April 2005

Source: Moerman, LC and Van der Laan, S, Accounting for Intellectual Property: inconsistencies and challenges, Journal of Intellectual Property, 11(4), 2006

Legal discourse recognises intellectual property rights as a sub-group of intangible subject matters that warrant special treatment.[97] In relation to this treatment there are entitlements or rights which exist under certain legal regimes. One such regime is the World Trade Organisation's (WTO) TRIPS Agreement which has sought to harmonise domestic legal arrangements regarding IPR. TRIPS was developed with the overarching objective of fostering economic and social welfare. The process of harmonisation of rules under TRIPS is not dissimilar to the internationalisation of accounting standards. Both have emanated from a multi-lateral rule making body seeking consensus or standardisation in an attempt to facilitate the trade in both goods and services. TRIPS and IFRSs both offer a principles-based approach to intangibles for adoption in domestic regimes.

Accounting for intellectual property rights generally falls within the subset of accounting for assets. The special treatment or asset recognition in this case relies on the rules which govern the accounting procedures. If we consider patents as an example where legal and accounting discourse intersect, the differences become obvious. In law, the intangible is the creative and novel discovery which is granted exclusive rights for a period of time according to a patent law. In accounting, a patent only exists as an asset if it has been purchased at an "arm's length" transaction and has future economic benefits that will accrue to the entity which can be measured reliably in monetary terms. If these criteria are not met, the expenditure would then be charged against profit. Whilst the legal right grants exclusivity, the economic right is based on exclusivity of use, that is, the ability to control the use of the patent. Even where a company may legally 'own' a patent and control its use, it may not be valued or measured as an asset for accounting purposes unless it can be demonstrated that it is probable that's it use will generate future economic benefits. Therefore, the mere purchase of a patent does not necessarily result in an asset being recorded. This issue is further complicated by the requirement to revalue intangible

[97] Christie A, Intellectual Property and Intangible Assets: A Legal Perspective, Intellectual Property Research Institute of Australia Occasional Paper, Intellectual Property Research Institute of Australia, University of Melbourne, No. 1/05, April 2005

assets periodically in an ‘active market’. Patents by their very nature are exclusive and hence no active market exists.[98]

A major ramification of these inconsistencies is that the investing community looks to publicly disclosed accounting information for decision making. Accounting discourse reinforces the view that accounting provides objective information by representing economic transactions as ‘true and fair’. The complexity of providing information regarding the recognition and valuation of intangibles, in particular IP can be attributed, in part, to the inconsistencies of the underlying assumptions of the regimes for recognising IP. This mismatch between the legal right and the economic right creates the discourse gap which presents challenges both companies and investors.

6. Challenges

Not so long ago, protecting and managing intellectual property was a fairly quiet field of endeavour not given to making headlines or causing ripples on the stock market. However in the space of a few years, IP issues have come to feature regularly as major news items and have taken their place as a key element in corporate strategy, affecting company ratings[99].

The market value of a firm and its accounting book value are rarely consistent. The primary reason for this inconsistency is said to be the market’s assessment of the value of intangible items.[100] A contributing factor is the difference in fundamental characteristics of rights and assets are summarised in Table 3 below:

[98] Moerman, LC and Van der Laan, S, Accounting for Intellectual Property: inconsistencies and challenges, Journal of Intellectual Property, 11(4), 2006, pp. 243-248

[99] Idris K, Intellectual Property: a power tool for economic growth (World Intellectual Property Organisation) 2004, p. 24

[100] Alfredson K, Leo K, Picker R, Pacter P and Radford J, Applying International Accounting Standards, John Wiley & Sons, Queensland, 2005

Table 3: Differences between accounting for intangible assets and legal requirements of IPR.

	Accounting (Assets)	Legal (IPR)
Recognition	Control An entity that controls the use of an asset and accrues economic benefits recognises that asset in the balance sheet.	Ownership
Value	Future economic benefits that are probable to accrue to the entity.	Exclusivity - a notion linked to the economic concept of monopolies and markets.
Defining Characteristic	The ability to measure reliably in monetary terms.	Inventiveness, novelty.
Life	Based on the ability to continue to create future economic benefits.	Limited to a specified time period in certain circumstances (e.g. patents)
Representation	Based on objective criteria (e.g internal generation generally not permitted)	Based on subjective criteria (e.g innovation derived from human endeavour)

Source: Moerman, LC and Van der Laan, S, Accounting for Intellectual Property: inconsistencies and challenges, Journal of Intellectual Property, 11(4), 2006

The above table demonstrates the disparity in the legal and accounting perspectives. One is a legal right whilst the other is an economic right. One controls access to knowledge whilst the other explicitly controls distribution of profits. Altering the way intangibles are accounted for does not alter the fundamental characteristics of a corporation, however conversion to international accounting standards can have a direct influence the ‘numbers’ reported and hence affect benchmarking and possibly have effects in financial markets. Companies may find difficulty attracting investment if there is a lack of supporting economic ‘stories’ regarding IPR. For example, Roche which is a listed company based in Switzerland and therefore required to be IFRS compliant as part of the European Union explained to investors the significant effect of adopting IFRS. Roche will present to the financial community the implications of the recently published IFRS changes that are effective 1 January 2005. Since 1990, Roche has applied

IFRS/IAS and is one of the largest preparers of IFRS Financial Statements in the world. The IFRS changes do not alter the economics of the underlying business transactions, however, they will increase transparency in the financial statements and improve comparability amongst companies. The announced changes are expected to have a positive net effect on Roche's operating profit and net income. As such, Roche expects an increase in net income of more than CHF 300 m for 2005 and 2006 (continuing businesses, before presentational change as per IAS 1 revised)[101].

Arguably, accounting has also been a contributing factor in the recent flurry of corporate restructuring in the pharmaceutical industry as companies strive to protect and manage patents as identifiable intangible assets in their financial reports[102]. Table 3 below summarises the mergers and acquisitions involving the top pharmaceutical companies since 2001.

Emerging as the likely 'winners' from the internationalisation process are multinational corporations that have a vested interest in protecting their monopolistic profits and facilitating investment though asserting both their legal and economic rights. Certain industries which rely heavily on the reporting of intangible assets in the market place (such as the 'pharmaceutical industry') have been active participants in the political processes that have resulted in global regimes that protect and enhance these legal and economic rights[103].

7. Concluding Comments

Accounting rests on the twin pillars of the efficiency of markets and representational faithfulness for valuation at both asset level and corporate level. In a world where a significant number of the most powerful economic entities are corporations and intangible assets like reputation and technological innovation carry enormous value, the space occupied by IP is important. Acknowledging this importance, various constituencies have sought to develop international frameworks to allow the creation, identification, protection and management of IP. IAS 38 has sought to harmonise the accounting treatment and agreements such as TRIPS has sought to standardise the legal treatment for IPR. However, these two regimes are not necessarily aligned

[101] Roche, Investor Update, 8 March 2005 (www.roche.com) accessed December 15, 2014

[102] Oram J, Addicted to Profit, Corporate Breakdown, 2, September 2002.

[103] Moerman L and van der Laan S, TRIPS and the Pharmaceutical Industry: Prescription for Profit, Critical Perspectives on Accounting 2006 in press

and the contested domain of IP extends beyond the problem identified as a ‘knowledge gap’. It can be viewed also as a ‘discourse gap’. Despite its importance in modern business, accounting for intangibles, in particular IP remains a challenge for both preparers and users alike. This Part has sought to highlight the inconsistencies and challenges under a global regime for accounting for intangibles, in particular, the lack of symmetry between the different discourses in which IPR are acknowledged. This Part contributes to an extensive IP literature from an accounting perspective and seeks to highlight that accounting does not make the same type of distinctions as is evident in the plethora of legal arrangements for IP. In accounting, the distinguishing characteristics are related to financial or economic criteria. The introduction and adoption of international standards for accounting sought to address the inconsistencies within accounting and similarly TRIPS sought to address the same issue for IPR. Potential solutions may lie in the harmonisation across regimes, how this may be affected remains a challenge for policy makers in a globalised environment.

C. Conflict based factors

I. General Provisions

1. General Conditions or Limitations on the Availability of Damages

The general conditions for awarding damages, in principle, include: infringing act, damage and causal link between the infringing activity and the damage. The previous two Sections demonstrated that a low transfer price often weighs against IP being found infringed. But if IP is found infringed, then the fact finder must determine the monetary damages to award to the IP owner. Transfer prices are highly relevant to damages.

The majority of the countries require at least negligence for awarding damages, and therefore state of mind plays a role. However, for a significant number of the countries, the mere violation of an Intellectual Property Right will suffice for an award of damages.

There seems to be an exception for copyright cases, where in Sweden, even good faith infringements are eligible for damages awards. This stands in contradiction to patent cases (and utility models cases) where some countries will not grant damages for good faith infringements.

Most countries award damages regardless whether an infringement is committed on a commercial scale. However, for example Sweden grant damages only for infringements committed on a commercial scale. There seem to be no overall limitations on damages.

Damages for IP infringement are typically based on the profits or royalties that the IP owner lost as a result of the infringement. A low transfer price for IP indicates that the IP owner expected low profits and royalties from the IP, which supports correspondingly low damages for infringement. In connection with previous two Sections, in author's opinion tax transfer price provides the one of the best measure of damages, because the transfer price is arm's-length to comply with tax law. However the transfer price of the IP should not be the sole measure of damages – or even the primary measure. But the low transfer price would be additional, relevant data for the fact finder to consider. Author states that damages in IP cases require not mathematical exactness but only a reasonable approximation.

2. Determination of Damages

a. Lost profits

Almost all of the countries in Europe appear to take into account right holders' lost profits when calculating damages awards. Lost profits are usually defined as profits that would have been earned by the rightholder in the absence of the Courts often do not provide for detailed calculations how lost profits have been infringement or profits that could have been justifiably expected (therefore not including the infringer's profits). A lower transfer-price suggests lower lost profits, because the transfer price reflects the profits the patent can earn for its owner. Thus, a low transfer price suggests lower lost-profits damages. If lost profits cannot be precisely determined, probable lost profits are estimated.[104]

Lost profits are sometimes determined by experts. As for the factors used to undertake the calculation of lost profits, it is often the net profit that is taken into consideration. The number of infringing products (this is sometimes reduced due to the difference in quality and higher price of the original product) is multiplied by a price per product as determined by the court.[105]

As for possible defences that buyers of infringing products would not have otherwise bought a genuine one, some courts for example Swedish courts have developed innovative solutions that apply ratios, for example 1:3 - original: counterfeit.

Courts often do not provide for detailed calculations how lost profits have been determined. It seems uncertain whether lost profits are available as an alternative or as a complement to a reasonable royalty.

b. Reasonable royalty

The other primary measure of damages is an award of a "reasonable royalty," which courts use in two main situations. First, the rightsowner may lack sufficient market evidence to demonstrate actual lost profits. Or, second, the rightsowner may not sell the patented invention itself, but instead make money by licensing the patent to others who do sell the patented invention.

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[104] Harguth, A., Carlson, S., Patents in Germany and Europe: Procurement, Enforcement and Defense : an International Handbook, Kluwer Law International, 2011 pp.35-37

[105] Cotter, T., Comparative Patent Remedies: A Legal and Economic Analysis, Oxford University Press, 2013 p. 14

Generally is provided for reasonable royalty damages in the amount of royalties that would have been due if the infringer sought an authorisation (licence) from the rightholder. The standards for a patent-law “reasonable royalty” and tax-law’s requirement for a valid transfer price are strikingly similar. Both require a hypothetical “arm’s-length” negotiation between willing, uncontrolled parties. Both involve looking to the most closely comparable transactions.[106]

Transfer prices are relevant to patent damages – not that the damages inquiry should end with the transfer price. Courts look to multiple factors in determining a reasonable royalty, with comparable transactions being only the first among the many factors. For example, even if a low price to transfer a patent to an Irish subsidiary might indicate a correspondingly low reasonable royalty, it might be necessary to adjust upwards if the patent holder and infringer are competitors, who generally demand higher royalties from each other.

Where a licence royalty is already fixed and used in the relevant sector, this amount will be used; if there is not an agreed royalty rate or it is difficult to determine precise rates, an estimated average royalty related to the specific type of business involved is often used.[107]

c. Actual prejudice

It appears that there is some confusion or uncertainty as to the dividing line between negative economic consequences and moral damages. Negative economic consequences are part of material damage (unlike moral, non-material damages). However, a minority of experts consider that economic consequences also include moral or immaterial damage.

Negative economic consequences are following: market disruption, damage to image and good-will, damage to distinctiveness, general price declines, losses of an internal nature, trademark dilution, etc. There seem to be diverging opinions in particular as to whether damage to good-will and trademark dilution should be considered as moral damages or as negative economic consequences.[108]

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[106] Slottje, D., Economic damages in intellectual property: a hands-on guide to litigation, Hoboken : John Wiley & Sons, 2006 p. 26

[107] Cotter, T., Comparative Patent Remedies: A Legal and Economic Analysis, Oxford University Press, 2013 p. 16

[108] Russell, P., Intellectual property infringement damages: a litigation support handbook, New York : John Wiley & Sons, 1999 p. 34

The reasons for using transfer prices as data for patent damages apply equally to copyright damages. Case law establishes that a copyright owner's actual damages "are usually determined by the loss in the fair market value of the copyright." As a result, a multinational's transfer price for a copyright should generally limit actual damages it can receive.[109]

Investments made by the rightholder in a brand or other IP are often not taken into consideration. Finland stated that contractual obligations have no direct effect on damages awards.

d. Moral prejudice

Moral prejudice forms part of actual prejudice. This kind of prejudice must be distinguished from the prejudice resulting directly from the infringement even though it is linked to it. Since this type of damage is difficult to assess, in most cases the amount awarded will be at the discretion of the court, and courts tend to award a lump sum as a moral damage.[110]

Compensation of moral damages may be done by apology, but also take the form of a monetary award. Damages for moral prejudice tend to be generally rather low.

e. Punitive damages

Most Countries refuse to apply damages that are explicitly punitive. Collecting societies sometimes provide for tariffs to offset damages that are multiple and these are sometimes seen as of a punitive character.[111]

f. "Innocent" Infringement

In most countries, the mere infringement of intellectual property right constitutes a tort and infringer's good or bad faith is irrelevant and does not affect the level of damages. In a minority of countries, no compensation is awarded if the infringer had no knowledge of the infringement

[109] Cotter, T., Comparative Patent Remedies: A Legal and Economic Analysis, Oxford University Press, 2013 p.17

[110] Derclaye, E., Research Handbook on the Future of EU Copyright, Edward Elgar Publishing, 2009 p.278

[111] Harguth, A., Carlson, S., Patents in Germany and Europe: Procurement, Enforcement and Defense : an International Handbook, Kluwer Law International, 2011 pp. 54-58

(i.e. was an innocent infringer). Compensation is awarded only for intentional or negligent infringements.[112]

In Sweden, there is a fairly heavy duty imposed on infringers to have investigated the market before putting potentially infringing products on the market.

3. Proof of damages

a. Evidence

The burden of proof lies with the claimant (plaintiff). The rightholder must prove the scope of the damage incurred.

As to evidence, common rules of civil procedure typically apply and give wide latitude as to the types of evidence that can be offered in proving damages. The courts decide if a respective fact can be deemed proven or not. The civil procedure in IP cases thus does not differ significantly from other civil cases. If the comprehensive evidence necessary to establish the full extent of damages cannot be produced (or only with difficulty), courts will sometimes undertake an estimate to set a reasonable amount of damages in accordance with a rule allowing diminution of the burden of evidence.

Moreover, the timeframe for the hypothetical patent-law “reasonable royalty” negotiation will often (but not always) overlap with the time of transferring the patent offshore for tax purposes. The “reasonable royalty” hypothetical negotiation is deemed to occur at the time of the *start* of the defendant’s infringement. Most tax-avoiding IP transfers are also done at an early date in the technology’s existence, to help justify the low transfer price. This closeness in time will make the patent’s transfer price particularly valuable evidence in determining damages.[113]

b. Other Factors

There are no standardised requirements regarding the type, scope or quality of evidence necessary to prove this type of damage. It is often determined on a case-by-case basis.

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[112] Russell, P., Intellectual property infringement damages: a litigation support handbook, New York : John Wiley & Sons, 1999 p. 67

[113] David I. Bainbridge, D., Intellectual Property, Pearson Education, Essex, 2009 pp. 173-180

The evidence that is usually required to prove damages relating to:

- the reputation of a trademark are in particular the following: market surveys or polls, documents proving the presence of the trademark within a particular sector, advertisements, copies of last Interbrand report, sales volumes, published articles, advertising campaigns;
- confusion/dilution: market searches, letters of complaints, evidence of consumer confusion, witnesses;
- price erosion and the investments made for the promotion: invoices, promotion campaigns, documents proving the price erosion (e.g. accountancy, contracts with distributors), expert's analysis; and,
- lost sales: comparison between the turnover before and after the infringement, terminated agreements as a result of better offers received from the infringing parties.

Copy of the licence agreement setting the amount of royalties may also be used. Statements from the relevant trade associations, from economics/technical experts or accountants (auditors) are also often used.[114]

Evidence of damage to goodwill is difficult to prove as there is a need to establish strength of a trademark. The fact that damages cannot be precisely proven does not mean that no prejudice has been suffered. In such cases, courts generally are willing to consider awarding damages in a lump sum.

[114] Derclaye, E., Research Handbook on the Future of EU Copyright, Edward Elgar Publishing, 2009 p. 298

II. Comparison of countries – Case Law

1. Estonia

A person, whose copyrights or neighbouring rights have been violated, can start a civil action in court. Under the paragraph 81^7 of the Estonian Copyright Act, protection of copyright and related rights is provided[115]:

(1) In the case of the unlawful use of a work an object of related rights, the author or holder of related rights may, among other, claim the following:
   1) Compensation, pursuant to paragraph 1043 of the Law of Obligation Act[116], for the patrimonial and non-patrimonial damage caused thought the unlawful use of the work or an object of related rights;
   2) Termination of the unlawful use of a work or an object of related rights and refrainment from further violation pursuant to paragraph 1055 of the Law of Obligation Act;
   3) Delivery of that which was received by way of the unlawful use of a work or an object of related rights pursuant to paragraphs 1037 and 1039 of the Law of Obligation Act;

(2) If, as result of violation of copyright legislation, a work or an object of related rights is communicated to the public, reproduced, distributed or altered etc., can entitled person may claim:
   1) Restoration of the work or object of related rights in the original form;
   2) Alteration of copies of the work or object of related rights by specific mean, or
   3) Destruction of pirated copies

(3) The provisions of clauses (2) 2) or 3) of this section do not apply to works of architecture.

(4) It is prohibited to transfer pirated copies to the author, holder of related rights or to their representatives.

The main provision on civil liability are therefore found in the Law of Obligation Act, since Copyright Act mostly refers to latter, only in Sections 2-4 are the stipulated provisions on civil liability relevant only as regards the specific nature of copyright-protection works.

[115] Estonian Copyright Act, RT I, 29.10.2014, 4

[116] Law of Obligation Act, RT I, 11.04.2014, 13

Under the paragraph 53 clause (1) 1) of the Estonian Patent Act, upon the unlawful use of an invention protected by a patent the patentee may request[117]:

1) Compensation for the damage caused by the unlawful use of the invention pursuant to paragraph 1043 of the Law of Obligation Act.

The main provision on civil liability is therefore found in the same Law of Obligation Act as provision for copyright. The paragraph 1043 of the Law of Obligation Act is provided:

- A person (tortfeasor) who unlawful causes damage to another person (victim) shall compensate for the damage if the tortfeasor is culpable for causing the damage or is liable for causing the damage pursuant to law.

The proprietor of a trademark may file a court action against a person infringing the exclusive right, including a licensee who violated the terms of the licence agreement[118]:

1) For termination of the offence
2) For compensation for patrimonial damage caused internationally or due to negligence, including loss of profit and moral damage

If an exclusive right is infringed by an employee or representative of an undertaking, the above action specified may be filed against the undertaking.

Case no 3-11-261/147

The detailed preview is in the part B of this Master Thesis. Shortly, the firm A claimed of refund of tax overpayment from the tax authority based on trademark sales contract. The tax authority established that the transfer price was artificially high and this trademark has no value at all. The tax authority was on position that the sale transaction was only with purpose of increasing the deductible input VAT.

The court decides that this not prove of the trademark value from the owner, because there in opinions submitted by the owner is not reference to the methodology of calculating the value of

[117] Estonian Patent Act, RT I, 12.07.2014, 105

[118] Estonian Trademark Act, RT I, 28.12.2011, 4

the trademark. The court uses the assessment submitted by the tax authority made by consulting firm for estimate the value of trademark.

The Supreme Court said that in this case is exceptional situation because of the circumstances of transaction referring to the suspicion that the buyer has the purpose by this transaction to achieve a greater amount of deduction of input VAT. It was indeed the average of complex administrative matter, but the resolution of the dispute took place in a reasonable amount of time. Since 37.5% of the appeal is satisfied, the procedural part of the cost of justice in the same proportion.

This case shows that evidence for transfer pricing and reference to the methodology of calculating the transfer price of intellectual property is required. Therefore, based on this case the conclusion is that parties of the contract should follow the arm's length principle of transfer. Tax administrations, thereby, lack justification to argue for higher transfer prices for intellectual property in situations where value of the IP cannot be objectively observed.

Reflecting the general law in Estonia there is no commercial scale requirement for claiming the compensation of damages in IP cases. The Law of Obligations Act[119] prescribes as direct patrimonial damage the reasonable expenses which have been incurred or will be incurred in the future due to the damage, including reasonable expenses relating to prevention or reduction of damage and receipt of compensation, including expenses relating to establishment of the damage and submission of claims relating to compensation for the damage.

If the damage is established but the exact extent of the damage cannot be established (including in the event of non-patrimonial damage or future damage) the amount of compensation shall be determined by the court without legal basis. The court may, if this is reasonable, determine compensation for the damage as a fixed amount, taking account, inter alia, the amount of fee the violator should have paid if he or she had obtained authorisation for the use of the relevant right.

To proof his damage, right owner have to present evidence proving the existence of IP infringement and evidence proving that the IP infringement was committed by the defendant; evidence proving that the act of the defendant was unlawful and evidence proving the sum of damages. The defendant needs to prove that he is not culpable for causing such damages.

[119] Law of Obligation Act, RT I, 11.04.2014, 13

In the presented case an action is satisfied in part, the parties shall bear the procedural expenses in equal parts unless the court divides the procedural expenses in proportion to the extent to which the action was satisfied (paragraph 163 of Code of Civil Procedure)[120]. The procedural expenses in civil court proceedings are the legal costs, presented case shows it.

Which legal theory should be used when making monetary claims against the infringer (compensation of damages or unjustified enrichment)? Compensation of damages could be claimed only regarding such infringement that has been proven.

Main problems in Estonian law:

1) Proving the amount of damages. Sometimes the courts request evidence that would be difficult or even impossible to present. The last most significant case were, when recognised as dead person, person came to court and court request the evidence, that this person is alive.
2) No punitive damages or statutory damages available in Estonia.
3) Civil proceedings are not very effective – they are slow, sometimes extremely difficult, and costly to right holders and have no expected effect.
4) The protection of IP is not a government priority. Enforcement institutions (police, prosecutor's office) are not interested of investigating IP violations. The laws of Estonia make it also almost impossible to fight against internet piracy in Estonia.

2. Finland

Section 57, paragraph 1 of Finnish Copyright Act[121] provides that the author is entitled to fair compensation for any unauthorised use. Section 57 paragraph 2provides that if such use is wilful or arise from negligence, then the delinquent party must, in addition to fair compensation, also pay damages for any other losses, together with pain and suffering and other injury.

The author is always entitled to fair compensation regardless of whether or not the delinquent party has been negligent, Fair compensation is intended only to constitute compensation for the use of the work and comprises no elements of indemnification. In the Supreme Court judgment

[120] Estonian Code of Civil Procedure, RT I, 19.03.2015, 26

[121] Finnish Copyright Act, Act No. 404 of July 8, 1961, as amended up to April 30, 2010

SC 1968 II 81 Tammelundin Liikenne Oy fair compensation was held to be twice the amount of the normal licence fees. It should be noted that this does not have the status of a general rule, even though authors often claim twice the amount of the normal licence fee as fair compensation.[122]

The injured party is entitled to damages for such injuries as reduced sales, market damages, direct losses and so on. Damages for pain and suffering and for other injuries are paid only rarely. The provisions of the Act on Damages and Tort Liability[123] are also effective with regard to damage payable in case of this kind. It should be noted that according to a general rule of Finnish tort law, the injured party is not to be put in a better position than that in which he would have been had the injury not occurred.

At the request of the injured party the court may order that unauthorised copies or copies of works which have been altered in a prohibited manner are to be destroyed, altered or conveyed against compensation to the injured party (sect. 58). However, this does not apply to a party which has obtained the property or a specific right thereto in good faith.

Section 57 to 68 of Finish Patents Act[124] provide for various kinds of remedies and sanctions in cases of infringement of a patent, the nature of which depends on the liability of the offending party. The most important remedies, however, are compensation and damages. Firstly, the infringer must always pay reasonable compensation for the exploitation of the invention. Secondly, he must pay damages where the infringement has caused injury to the other party (Sect. 58, para. 1). The compensation is equal to the amount that normally would have been paid in licence fees for such exploitation under an agreement. The infringer must pay compensation even where the proprietor has suffered no damages whatsoever. Thus, the compensation is a minimum indemnity to which the injured is always entitled.

The amount and type of damages depends on the degree of culpability of the infringer. Where the infringer has acted intentionally or negligently, he must pay reasonable compensation and full damages. In the case of slight negligence, the compensation and damages may be adjusted

[122] International encyclopaedia of laws: intellectual property. Vol. 3. The Hague : Kluwer Law International , 1997 pp. 60-Finland

[123]Finnish Act on Damages and Tort Liability, , Act No. 412, 1974

[124] Finnish Patents Act, Act No. 550 of December 15, 1967, as last amended by Act No. 896 of November 11, 2005 (FI076)

accordingly. Where the infringer has acted neither intentionally, he is liable to pay compensation only if, and to the extent, that this is considered reasonable (Sec. 58, para. 2).

In considering culpability, the knowledge of the infringer that he was infringing a patent is not relevant, but it is what he should have known that is relevant. In principle everybody is deemed to have knowledge of all patents and published applications, however, in practice only importers and manufacturers have a strict duty to make investigation concerning patent and applications. Others, such as distributers, wholesales, etc., do not have such a strict duty to make inquiries.[125]

In case of infringement, the Finish Trademark Act provides various kinds of remedies. Section 38 provides that anyone who infringes the right to protected trademark may be prohibited by Court from continuing or repeating the said delinquency unless there are special reasons to the contrary. This is, in practise, the most important sanction.[126]

Section 38, paragraph 2 provides that if infringement has been deliberate or has arisen due to negligence, then the injured party is entitled to compensation for any damage suffered. the damages and compensation to which the proprietor is entitled depend on the degree of culpability of the infringing party. The damages may be adjusted as deemed reasonable if there has been only slight negligence. However, normally it would have been the duty of infringing party to investigate whether the mark in question was protected, especially where it had been registered. Indemnification consists of compensation for falls in sales, for market damages and for direct losses and costs. In the case of falls in sales, it is the losses of the proprietor which determine the damages, not the profits of the infringing party. Market damages consist, for example, of losses in the goodwill of the trademark because of the lower quality of the goods. It is difficult to the courts to estimate the damages in practice.[127] Case law in Finland includes various examples on how intellectual property disputes are being solved.

Supreme Court's decisions with their respective decision numbers KKO:1989:87, KKO:1989:151, KKO:1996:43, KKO:1995:202, KKO:1998:91, KKO:1999:115, KKO:2001:42,

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[125] P.-L. Haarmann, A Textbook on Intellectual Property Rights, 2en ed, Lakimiesliiton kustannus, Helsinki 1994, pp. 118-119

[126] Tiili, V. Aaro, P-L., An Enterprise`s Guide to Trademarks and Registration of Designs., Kauppalehti Business Book, Jyväskylä 1986, p69

[127] Koktvedgraard, M., Levin, M, A Textbook of Intellectual Property Rights, Norstedts Juridik, Stockholm 1995, pp. 405-407

KKO:2005:43, KKO:2007:63, KKO:2010:47 and KKO:2011:92 all deal with copyright infringements.

In legal praxis (KKO 1989:87, KKO 1995:202, KKO 1998:91 and KKO:2001:42) starting point for an assessment of reasonable compensation has established to be normal compensation for the use.

Supreme Court decisions KKO:1989:151, KKO:1999:115, KKO:1996:43, KKO:2007:63 and KKO:2010:47 at the same time demonstrate that not in all cases normal license fees or market prices can be used in the raw. These cases verify that special characters of each case are required to take into consideration in determining whether normal licensee payment can be used as such.

Supreme Court KKO:2005:43

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

In this case the Supreme Court found that the reasonable compensation is the amount the copyright owners would have charged from the copyrights if they had negotiated the licensee fee under normal market circumstances without the infringement. Since the vocabularies, used in the diskettes, could be acquired by buying the textbook, the court determined the reasonable compensation for each diskette to be the market price of the textbook. The market price was then multiplied by the amount of diskettes sold in order to get the total compensation.[128]

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

[128] Laine. A., Transfer pricing of intangible assets - Implications of Finnish intellectual property case law on valuation of intangible assets, Aalto University - Master's thesis, 2012 p. 58

This court case is a good example on how reasonable compensation in copyright cases is determined and on how soft intangibles are analysed in the courtroom, the court uses the market price of an infringed product and multiplies it by the amount of an infringed product. This particular case and all the other similar cases where a reasonable compensation is based on market prices clearly favour the CUP/CUT method in transfer pricing, this method detailed in Part A on page 24 in this Master Thesis. In Supreme Court decision KKO:1995:205 it has been concluded that generally in the case of copyright infringement the amount lost in operating income is the compensation for damages. Another important implication of the court' decision is that actual evidence is needed in order to condemn compensation for damages.

Supreme Court KKO:2005:105

Fiskars PLC (Fiskars), a holder of a copyright of design had sent a letter to retailers of its competitor Rediviva Ltd (Rediviva). The letter argued that Rediviva's product infringed the copyright of design and all actions infringing the copyright of design must be stopped. The Supreme Court found that Rediviva's product did not infringe the copyright of design and that there was a cogent reason that the procedure of Fiskars had caused damages to Rediviva.

Rediviva demanded compensation for damages for three reasons; lost license payments for lost sales of claimed product, decrease in sales of other products under the trademark Finman and impairment of trademark value. The court found Fiskars to pay damages for lost license payments.

Compensation for damages due to decrease in sales of other products and impairment of trademark value were not granted. In determining lost license payment the court based its assessment of appropriate royalty rate on contract that Rediviva had made with its retailer before the retailer stopped purchasing Rediviva's product. The court then multiplied the royalty payment by number of lost sales measured in product units. The amount of lost sales in units was assessed based on expected sales of Rediviva's products. Rediviva's expected sales, on the other hand, were estimated by purchase receipts verifying orders of Rediviva's product and by hearing expert opinions on expected total sales of similar products in the market. Rediviva claimed that the accusations of Fiskars had decreased sales of other Finman trademark products as well and had led to the impairment of the trademark value. The court however dismissed the damage claims on these matters. The court found that Rediviva was not able to prove the impairment of its trademark.[129]

As can be seen from the case the Company sending out the letters had breached the Unfair Business Practices Act (1061/1978) by sending out a warning letter to retailers of a certain product. The warning letter claimed that the product infringed the Company's design rights, and prohibited the retailer from selling the product. However, it was subsequently decided that the product in question did not infringe the Company's design rights. As a result, the Company was held liable for any damage incurred by the retailer due to the warning letter.[130]

Burden of proof lies with the plaintiff. Assessing damages involves calculating an amount that is equivalent to a reasonable royalty. The court endorsed its decisions to use royalty rates agreed in the particular contract by revising royalty rates that other retailers had paid to Rediviva. Compensation for impairment of the value of the trademark and for decreased sales was dismissed by the court due to the lack of evidence. Goodwill damage is difficult to prove, since it's a long term loss. Price erosion is difficult to prove and estimate as well.

If the amount of damages is difficult to prove, the court will estimate the damages. Finally, however, in this case compensation was only granted for lost license payments but not on the basis of soft intangibles. Anyway rightholder must be compensated (reasonable compensation) even in good faith infringements.

In author's opinion the most problem is that Finish law has not general formula for calculating damages. Uniformity in damages calculations is assured that one court is dealing with all infringement cases.

3. Germany

Case I ZR 87/07 – Zoladex

The defendant imported a pharmaceutical product of the claimant from another country of the European Union and marketed it in Germany. The parallel import company had modified the package of the original product for the German customer. The pharmaceutical company's trademark rights are not exhausted and the pharmaceutical company can stop the marketing of its

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[129] Laine. A., Transfer pricing of intangible assets - Implications of Finnish intellectual property case law on valuation of intangible assets, Aalto University - Master's thesis, 2012 p. 72

[130] Monthly brief at http://www.roschier.com/

original products on the basis of its trademark if the original product or packaging has been modified in any way, unless the parallel import company has complied with a set of obligations. One of these obligations of a parallel import company is to inform the pharmaceutical company about the modification of the original package before putting it on the market. The defendant had failed to do so and the claimant therefore was granted an injunction ordering the parallel import company to stop any further marketing of the pharmaceutical company's product. Further, the defendant was ordered to pay damages.

With respect to the damages, the Federal Supreme Court awarded damages corresponding to the full amount of profit the defendant had made. The court did not follow the defendant's argument that the defendant would have been allowed to market the pharmaceutical product if he had informed the claimant about it before so that only a small part of its profit, if any, would have been causally connected to the trademark infringement. On the contrary, the Federal Supreme Court emphasized that the pharmaceutical product could not have been marketed without the claimant's trademark, due to reasons of pharmaceutical law. The court therefore found that the parallel import company's profit had been completely caused by the trademark infringement and therefore awarded damages to the claimant corresponding to the full amount of profit the parallel import company had made by marketing the pharmaceutical company's product in a modified package.[131]

In order to give effect to the idea of balancing in the calculation of damages with reference to the profit made by the infringer it is assumed that the owner of the right would have made the same profit which the infringer made.

Also according to the German Law the victim can claim lost profits due to the infringement, reasonably royalties in relation to the infringement and surrender of the actual profits generated by the infringer.[132]

According to Civil Procedural Law[133] certain discretion of courts to freely estimate minimum amount awarded, in case sufficient indications.

[131] Hartwig. H., Tilman Müller-Stoy. T., IP case law - Selected decisions, Bardehle Pagenberg, 2011, p. 127

[132] Klett, A., Intellectual property law in Germany: protection, enforcement and dispute resolution, Beck, C H, München 2008, p 71

Adequate license fee which is calculated according to a fictitious license agreement under which it would be irrelevant to what extent the rights were actually used by the infringer. In particular, it is feigned that a distribution right would have been licensed for all goods produced (and not only for those sold). Early discovery of the infringement does not help the infringer. However, probable that the license fee agreed later will have an impact on the calculation of damages, in case it is calculated as reasonable license fee.[134]

Rightsowner bears the burden of proof. No special formal requirement to prove damages. Common rules of civil procedure apply. According to case law, the requirements to prove damages should not be handled too strict; in particular the calculation according to reasonable license fee is meant to help the right owner. Additionally, information claims help rightsowner to obtain information from infringer.

According to the German law the rightholder has rights of information against the infringer and also against third persons if the infringement is committed on a commercial scale (right of information). In cases of commercial scale infringements, the trademark owner can also demand the communication of banking, financial or commercial documents or an adequate access to such documents which are in control of the infringer and which are necessary for the enforcement of the damages claim. In case of confidentiality of the documents, the court takes the necessary measures to guarantee the required protection in the single case.

Market value and reputation of trademark, likelihood of confusion, parallel trade, actual lost sales, infringing sales, price erosion, toleration of prior comparable infringements may be factors (sometimes indirectly) influencing the calculation of damages. The costs of a patent attorney in trademark, design right, patent law, plant variety protection and utility model law cases have to be covered by the loosing party.[135]

Court held that the reasonable license fee may be calculated according to the own licensing practice of the rightsowner, in case the right owner had concluded a sufficient number of

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[133] German Code of Civil Procedure as promulgated on 5 December 2005 (Bundesgesetzblatt (BGBl., Federal Law Gazette) I page 3202; 2006 I page 431; 2007 I page 1781), last amended by Article 1 of the Act dated 10 October 2013 (Federal Law Gazette I page 3786)

[134] Klett, A., supra at pp. 14, 65,107

[135] Klett, A., supra at pp. 601-609

licensing agreements in this amount. This usual licensing practice by the rightholder may be higher than the usual market licensing price.

Three following problems have place in German law: first is liability of intermediaries (scope of obligations, proactive measures), second is goods in transit and the third is anonymity of internet commerce.

4. United States

There are jurisdictions, like U.S.A., in which, if looked at from the viewpoint of an “innocent” observer from a country like Estonia, the main purpose of a patent infringement procedure seems to be to get damages from the infringer, the injunctional relief described above being of less importance. The reason may be that in a jurisdiction like in U.S.A. the amount of damages sometimes is giant, compared with European habits, whereas for an observer from e.g. U.S.A. the amount of damages that can be collected in a country like Estonia sometimes appears as ridiculous. Accordingly, as a general observation one might duly say that in Europe, the injunctional relief is the main fruit of a successful patent infringement action, while in e.g. U.S.A. the real fruit consists of the damages.[136]

Large monetary awards in patent infringement cases are certainly capable of grabbing headlines. For example, in 2012 a jury in California awarded Apple $1.05 billion in damages for Samsung’s infringement of several Apple patents.

The Court of Appeals for the Federal Circuit, which hears all appeals of patent cases, has recently issued several opinions on this damage topic. One such case, Lucent Technologies, Inc. v. Gateway, Inc., 580 F.3d 1301, 1337 (Fed. Cir. 2009), emphasized that a patent owner is required to separate or apportion the damages attributable to the patented features contained in the accused product to the exclusion of any profits attributable to unpatented features.

This concept, known as apportionment, is not a new development in the law. In fact, it finds its roots in Supreme Court precedent from the late 1800s. See Garretson v. Clark, 111 U.S. 120, 121

[136] Appelt. C.W., Enforcement of Patents in Europe – Germany as an Example, Boehmert & Boehmert and Forrester & Boehmert, Munich 2006

(1884). But it is again coming to the fore as the Federal Circuit attempts to rein in oversized patent damages awards.

There are generally two types of monetary damages in US patent cases: lost profits and a reasonable royalty. Lost profits are only available in limited instances, such as when a true competitor is harmed by loss of sales of its product. A reasonable royalty, on the other hand, is much more common and the statutory minimum to which a patent owner is entitled when its patent is infringed.[137]

A reasonable royalty has two components, the royalty base and the royalty rate, which when multiplied together determine the total royalty (i.e., royalty = base * rate). The royalty is intended to be the result of a hypothetical negotiation that would have taken place between the parties at the time just before infringement began, one in which the alleged infringer as a willing licensee would have taken a license from the patent owner, a willing licensor.[138]

The choice of base is critical in a reasonable royalty analysis. Even though a large base (e.g., the entire value of a car) can be offset by a small rate, the Federal Circuit requires a reasonable choice of base so as not to "skew the damages horizon for the jury . . . ." Uniloc USA, Inc. v. Microsoft Corp., 632 F.3d 1292, 1320 (Fed. Cir. 2011).

Case Law: Uniloc USA Inc. et al. v Microsoft Corporation

Uniloc claimed that Microsoft's Product Activation System, used on Microsoft software programs such as Word XP, Word 2003 and Windows XP software, infringed its patent. The US Court of Appeals for the Federal Circuit found that Microsoft infringed the patent. The most significant statement of the Court, however, relates to damage claims because the Court decided that the 25 percent rule of thumb used to estimate a fair royalty was "fundamentally flawed" and it no more held any evidential value before a US court.

[137] Feigelson, A., Brandt, M., Shrestha, R., The Importance of Apportionment in Calculating Damages for Patent Infringement, Chicago Daily Law Bulletin, March 16, 2015

[138] Feigelson, A., Brandt, supra at 75

The plaintiffs had applied so called “25 percent rule of thumb” in determining the damage claims. “25 percent rule of thumb” hypothesizes that 25% of the value of the product would go to the patent owner and the other 75% would remain with the licensee.

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

The 25 percent rule has, however, countered harsh criticism that could be separated into three factors; (1) firstly the rule fails to account for the unique relationship between the patent and the accused product. It is claimed not to take into account the importance of the patent in profit generation of a particular product. The court discussed that for narrow patents, the rule may be overly generous to the patentee and for broad patents it may be overly stingy. (2) Secondly, the rule fails to account for the unique relationship between the parties. It does not consider the context, the negotiation power of the parties or the risk assumed by the licensor and the licensee. (3) Thirdly, the rule is essentially arbitrary and does not fit within the model of the hypothetical negotiation within which it is based.

The rule does not take into account a particular hypothetical negotiation or special characteristics of the parties or the property involved. Relying on the 25 percent rule of thumb in a reasonable royalty calculation is far more unreliable and irrelevant than reliance on parties’ unrelated licenses.

The obvious conclusion of the case is that the “25 percent rule” no longer applies to any valuation of intellectual property, which includes a US licensee or licensor, another important learning of this case for transfer pricing is the court’s willingness to apply arm’s length pricing.

Case law: Georgia-Pacific Corp v. US Plywood-Champion Papers

The statutory authority for the district court's award was 35 USC § 284, which provides in relevant part that the court shall award the claimant damages adequate to compensate for the infringement, but in no event less than a reasonable royalty for the use made of the invention by the infringer.

The parties seem in essential agreement that the trial court correctly chose to apply the 'willing buyer-willing seller' rule in determining a reasonable royalty under that section. This rule contemplates a suppositious meeting in advance of infringement between patent owner and potential infringer in order to work out a license agreement.

The trial court found a wide range of factors relevant in such hypothetical negotiations and carefully considered whether there was competition between the plaintiff's product (Weldtex) and other kinds of panelling. The effect of both the cyclical popularity of specialty plywoods and the short time the patent had to run. Plaintiff's profits on sales of Weldtex and collateral sales of other products were occasioned by sales of Weldtex. The defendant's expected profits on both striated plywood and collateral sales. The importance of the Deskey patent relative to other processes necessary for producing the plywood and Weldtex's decorative quality and whether there were comparable prevailing royalties on either Weldtex or similar products.

The Federal Circuit suggests use of the smallest salable patent-practicing unit (or "SSPPU") for the base as a first step toward determining the royalty. LaserDynamics, Inc. v. Quanta Computer, Inc., 694 F.3d 51, 67 (Fed. Cir. 2012). But there is an exception to this rule, albeit a narrow one. If the accused technology is but one component of a product, such as the touch screen of a smart phone, then the entire market value of the product can be used as the base if the patent owner first proves the component covered by the patent serves as "the basis for customer demand" of the overall product. It is only in this limited instance that apportionment does not apply, and the entire market value of the product, of which the infringing technology is but one component, may be used as the royalty base.[139]

[139] Feigelson, A., Brandt, supra at 86

Aside from this exception, however, a patent owner must always apportion the base to ensure it is closely tied to the patented invention. VirnetX, Inc. v. Cisco Systems, Inc., 767 F.3d 1308 (Fed. Cir. 2014), another recent Federal Circuit case, reaffirms this duty. VirnetX holds that a patent owner must apportion even beyond the SSPPU if it contains significant non-infringing features with no relation to the patented feature. In other words, the patent owner may have to focus the royalty base even further to discount those unrelated features, all in an effort to more accurately "estimate what portion of the value of that product is attributable to the patented technology."

The size of an infringer's profits is often an influential factor in the determination of the amount of a reasonable royalty. In fact, the very definition of a reasonable royalty assumes that, after payment, the infringer will be left with a profit.

In Trademark infringement cases, in lieu of awarding damages, the court may order to the defendant to pay the plaintiff a sum of damages equivalent to the profits made from the infringing activity.

Payment of reasonable royalty is not a remedy as such, but reference to a licence fee or reasonable royalty is accepted as a method of calculating damages in IP rights infringement cases. In general, the damages and costs provisions are okay. However, a scale of damages to be awarded would be very helpful and would avoid ambiguity and uncertainty.

5. Concluding Comments

In Estonian legal system, laws form a base for law practice. Laws, however, can be unclear or open to various interpretations. In such situations law practice seeks answers from the legislative history of the law. In such a case that neither law nor its legislative history includes a response to a particular question, the court has the right to interpret the law. In case of the valuation of the IPR in author's opinion where is no special law the role of the court's decisions is very important. There seems a lot of well-established case law on the evaluation of damages.

An issue that has arisen from case-law relates to which legal theory should be used when making monetary claims against the infringer: whether it is for compensation to the rightholder for the prejudice suffered or whether it represents the infringer's unjustified enrichment. Another rather general and not necessarily IPR-specific problem is that civil proceedings can be long, costly and difficult.

The author stated that damages in the form of a lump sum are the preferred option though this will likely relate to the type of IPs concerned. This approach allows the right holders to claim from the infringer compensation in the full amount of relevant licence fee or retail price of the infringing product.

Judgements are generally not explicit or transparent as to how the damages are actually calculated. Some courts only award damages encompassing lost profits without taking into account other components of the prejudice suffered by right holders. Moreover, the courts often award a lump sum without any underlying justification.

Regrettably, national courts seem to grant damages in a single amount without differentiating between the different components of the prejudice. Judgments are often not very explicit or transparent on how the damages have been calculated.

Some courts allow damages for the costs of detecting and monitoring the infringement, while others consider that such expenses do not constitute a part of the prejudice. Moral prejudice and injury to reputation are often underestimated.

Indeed, proving the amount of damages can be distinctly difficult. Sometimes the courts request evidence that would be difficult or even impossible to present. It would be helpful if the right holders were always entitled to claim the infringer's profits as a minimum, because it seems that the infringer's profits are usually higher than the damages that can be easily proven, and it seems inequitable and not dissuasive if those profits are retained by the infringer.

Licence fees as the basis for IP damages calculations: courts generally have no problem in using standard licence fees (ex-VAT) as the basis for damages calculations.

In some countries, multiple (i.e. double) or additional damages awards are available for copyright and industrial rights infringements under various provisions. As a general matter, it is often very difficult to secure meaningful damages and compensation for legal costs. This means that in certain sectors damages actions are the exception and right holders will instead limit their activities to seeking injunctions to stop on going infringements. As a result, many infringers are not deterred from undertaking infringing activities and will regard any damages or legal costs as mere costs of doing business.

Conclusion

The main goal of this Master's Thesis is to find out that the valuation of the Intellectual Property value has not been regulated by the law and the need for such regulations of method choice in law is obvious. This hypothesis during this Thesis was fully confirmed. Lack of regulation and the need for them is obvious, but their urgent introduction is not necessary at this time, the situation with IPR value can wait a few next years, because the IPR is not in focus of protection of present legal system.

The valuation of intellectual property has become an increasingly more integral and more complex part of the legal and commercial environment. Numerous generally accepted methods may be appropriate to the analysis and appraisal of intellectual property. The final intellectual property value estimate conclusion involves the application of the analyst's professional judgment and experience to the intellectual property valuation process.

Analysts typically use more than one valuation approach to analyse the subject of IPR. The IP value typically is based upon the analyst's professional judgment and experience, results in the conclusion of an overall value estimate for the IPR.

An important component of IP valuation is assessing the legal protection afforded to the IP in each relevant jurisdiction. Legal protection is one factor that informs IP value because it permits the IPR owner to utilize formal legal systems to exclude third parties from infringing, thereby providing exclusivity.

As described in this Thesis, when valuation of intellectual property at the time of the transaction is highly uncertain, the question is raised how arm's length pricing should be determined. The question should be resolved, both by taxpayers and tax administrations, by reference to what independent enterprises would have done in comparable circumstances to take account of the valuation uncertainty in the pricing of the transaction.

When tax administrations evaluate the pricing of a controlled transaction involving intangible property where valuation is highly uncertain at the outset, the arrangements that would have been made in comparable circumstances by independent enterprises should be followed. Thus, if independent enterprises would have fixed the pricing based upon a particular projection, the same approach should be used by the tax administration in evaluating the pricing. In such a case, the tax administration could, for example, inquire into whether the associated enterprises made adequate projections, taking into account all the developments that were reasonably foreseeable, without using hindsight.

It According to this Master's Thesis author's request to the tax authority it is recognised that a tax administration may find it difficult, particularly in the case of an uncooperative taxpayer, to establish what profits were reasonably foreseeable at the time that the transaction was entered into.

Intellectual property may obtain value as a consequence of advertising and other promotional expenditures, which can be important to maintain the value of the trademark. However, it can be difficult to determine what these expenditures have contributed to the success of a product. The value and any changes will depend to an extent on how effectively the trademark is promoted in the particular market. For instance, it can be difficult to determine what advertising and marketing expenditures have contributed to the production or revenue, and to what degree. The low transfer price should be evidence weighing against famousness of the trademark.

Transfer price valuation is better evidence on nonobviousness of the patent. And "nonobviousness" is the most important requirement for patent validity.

According to the research of the author of this Thesis a transfer price has real legal significance. Transfer prices for IP and the contemporaneous expert documentation justifying the pricing are discoverable. Attorneys representing IP defendants should obtain discovery of both the transfer prices and the expert documentation.

This Thesis shows how IPRs are transferred early to subsidiaries in tax havens for low prices. Companies use IP-based approaches to avoid taxes to other countries, which has generated intense public anger in austerity-weary Europe.

Taxpayer inherently knows far more about the characteristics, potential, and value of its IP than does the tax administration (or any valuator). For example, Apple understands how its new invention could fit profitably into a new smartphone in a way that neither a team of Tax Board experts, nor a team of private valuators, ever could.

Taxpayers can fully comply with the law by disclosing all facts to their valuators who must determine the "arm's-length" transfer price. Any outsider (including judges) will not be able to discern its profit potential.

The problem that is the prevailing international tax law provisions in Europe date from work by the League of Nations in the 1920s. They are embodied in thousands of bilateral tax income tax treaties and in most countries' tax laws. They reflect the economic realities of the era where value was created through manufacturing interchangeable physical goods. Now that intangibles account for the bulk of the value of international commerce, these provisions are problematic.

The market value price is the most problematic provision, allowing IP transactions at easily manipulated prices. The other problematic international norm is respecting corporate subsidiaries as separate entities.

Current weaknesses in the tax law's transfer pricing regulations are obvious. Ambiguities in accounting standard create the potential for companies to manage their earnings by avoiding reporting tax liabilities for foreign profits, thereby improving the appearance of their financial statements to shareholders and investors.

IAS 38 has sought to harmonise the accounting treatment and agreements such as TRIPS has sought to standardise the legal treatment for IPR. However, these two regimes are not necessarily aligned and the contested domain of IP extends beyond the problem identified as a 'knowledge gap'. It can be viewed also as a 'discourse gap'. Despite its importance in modern business, accounting for intangibles, in particular IP remains a challenge for both preparers and users alike.

Accounting does not make the same type of distinctions as is evident in the plethora of legal arrangements for IP. In accounting, the distinguishing characteristics are related to financial or economic criteria. The introduction and adoption of international standards for accounting sought to address the inconsistencies within accounting and similarly TRIPS sought to address the same issue for IPR.

It would seem that potential solutions may lie in the harmonisation across regimes, how this may be affected remains a challenge for policy makers in a globalised environment. This would provide more certainty in IP infringement cases connected with its value.

As to court practice, it seems to be no well-established case law on the evaluation of damages. An issue that has arisen from case-law relates to which legal theory should be used when making monetary claims against the infringer: whether it is for compensation to the rightholder for the prejudice suffered or whether it represents the infringer's unjustified enrichment. Another rather general and not necessarily IPR-specific problem is that civil proceedings can be long, costly and difficult.

The author stated that damages in the form of a lump sum are the preferred option though this will likely relate to the type of IPs concerned. This approach allows the right holders to claim from the infringer compensation in the full amount of relevant licence fee or retail price of the infringing product.

Judgements are generally not explicit or transparent as to how the damages are actually calculated. Some courts only award damages encompassing lost profits without taking into account other components of the prejudice suffered by right holders. The court don’t have any idea how to evaluate the IP and relies only on expert opinion, which is highly questionable in view of there is no alternative presented in this case for valuation method choice. Judgments are often not very explicit or transparent on how the damages have been calculated.

Indeed, proving the amount of damages can be distinctly difficult. Sometimes the courts request evidence that would be difficult or even impossible to present. As suggested in this Thesis, it would be helpful if the right holders were always entitled to claim the infringer's profits as a minimum, because it seems that the infringer's profits are usually higher than the damages that can be easily proven, and it seems inequitable and not dissuasive if those profits are retained by the infringer.

This Thesis shows that the legal basis for the choice of IP valuation method is extremely needed. Further, IP value calculating is a wide spread problem and we ought to be creative in thinking of solutions on how to put a halt to it. Intellectual property valuation is integral part of the IPR protection and lack of regulations illustrates incomplete protection or complete lack of protection of IPR.

The current IP valuation situation with no special law regulating may be about to change. Due to the great differences and difficulties in legal factors and components of the influence of an IP valuation showed in this Thesis, this Master’s Thesis author suggests creating the law regulations in calculating the value of the IPR. This regulation has to be ready to use by companies, analytics and courts in 2-4 years. It should be in 2-4 years be a common method for evaluating the value of the IPR. As result of this Master’s Thesis author sees regulations containing several methods for evaluation that suit different situation showed in this Thesis. This Master’s Thesis author created as example following law regulation for the intellectual property valuation:

§ 1. Declaration of purpose

(1) The declaration of purpose shall specify the intended use, the addressed audiences, the identified asset, the premise of value, the position of the valuator and the valuation date.

(2) The valuation of intellectual property shall be specified in accordance with the purpose of valuation:

a) management information;

b) licensing;

c) legal transaction;

d) taxation;

e) accounting;

f) liquidation;

g) litigation support;

h) dispute resolution;

§ 2. Valuation approaches and methods

(1) Intellectual property shall be valued by applying the income, market or cost approach. The purpose of the valuation and the characteristics of the intellectual property being valued shall dictate which approach is utilized to calculate the value of the intellectual property.

§ 3. Income approach

(1) The income approach measures the value of the intellectual property by reference to the present value of the economic benefits expected to be received. The steps followed in applying the income approach shall include estimating the expected after-tax income streams.

(2) In order to determine the income streams generated by the intellectual property, the royalty relief method shall be applied. This method shall measure the value of the intellectual property as the present value of expected future royalty payments, assuming that the intellectual property is not owned but licensed. The value calculated through the royalty relief method thus constitutes

the present value of the royalty payments saved through the ownership of the intellectual property.

1) In case of infringement of intellectual property the royalty is 25 percent of sales price. Estimation of royalty is based on multiple infringements plus reputation plus other facts such as security standards.

2) In case where no infringement of intellectual property shall be used standard licence fees (ex-VAT) as the basis for royalty (sectoral market standard royalties shall be created in author's opinion).

(4) Cash flows in the income approach shall be calculated on the after-tax basis, the effect of tax savings through amortization shall be considered and calculated.

§ 4. Market approach

(1) The market approach measures value based on what other purchasers in the market have paid for assets that can be considered reasonably similar to those being valued.

(2) In order to be comparable, the transactions shall have been made within a reasonable closeness in time to the value date of the subject for valuation. The valuation shall take into account the fact that the actual price negotiated by independent parties in a transaction may reflect strategic values and synergies that cannot be realized by the present owner.

§ 5. Cost approach

(1) The cost approach measures the value of the intellectual property based on the cost invested in creating the intellectual property, or its replacement or reproduction cost.

(2) The cost approach can be used when the other valuation approaches cannot be implemented and there is reliable data to estimate the cost.

§ 6. Ownership

(1) The value determined in the intellectual property rights valuation shall only be attributable to the owner of the legal rights.

§ 7. Legal parameters affecting the intellectual property value

(1) The valuator shall take into account all legal parameters affecting positively or negatively the value of the intellectual property, including:

a) scope of use/scope of registration;

b) extent of use;

c) reputation of the intellectual property;

d) price erosion and the investments made for the promotion: invoices, promotion campaigns, documents proving the price erosion;

e) risk of cancellation, priority, dilution and the ability, or willingness, or both, of the owner to enforce legal rights.

It is highly likely that the effects of this Master's Thesis will influence the developing of these regulations in new Intellectual Property Code of Estonia. The author hopes that this Thesis takes effect on perception of IP value amongst courts, companies, legal practitioners and general analytics.

The regulations of evaluating of IP value may bring more certainty into how companies and courts calculate the IPR value. Will the courts be affected by this new regulations of evaluating IP value? Well, if the claimants can show good founded arguments for damage to IP based on these new law regulations, there may very well be a change in the awards for loss of IPR. Due to the vagueness of any existing calculation to establish damage, it could be a way forward to simply introduce punitive awards in the case of IP damage in the Estonian legal system.

All interviewed experts agreed that there is a problem with evaluation of IP value, but the protection of IPR is not a government priority and it will be greater focus within only in next 5-10 years. The slow development of the IPR protection may be explained by a recognised need to be careful in allowing excessive protection to right owners to the detriment of natural competitive market forces and the current legal system.

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