A “Quick Dip” in the Water—A Summary of Recent Transfer Pricing Issues

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Panel Abstract

This program will provide a “refreshing dip” into the latest and most significant transfer pricing issues. We will dive into the OECD’s recent proposal for a Unified Approach to the tax challenges of digitalization, including the proposed new tax nexus rule for in-scope taxpayers, revised profit allocation rules, and pending key questions. We will then splash around in the final and proposed BEAT regulations, focusing on issues such as non-recognition transactions that may give rise to base erosion payments, the lack of an exception for payments to foreign entities that are subject to GILTI and/or Subpart F, and additional clarification on whether payments can be netted against one another to reduce base erosion payments. We will next take a couple of laps through the recently released functional cost diagnostic model or “FCDM”, including some observations on how this model has been used in actual APA negotiations. Lastly, we will catch a few rays, shedding some light on recent transfer pricing litigation, discussing recent developments in major cases such as Amazon, Altera, Medtronic, and other significant cases.
Panel Outline

I. Part One – Hour 1
   A. OECD BEPS 2.0 Pillar One
   B. BEAT Final and Proposed Regulations

II. Part Two – Hour 2
   A. Functional Cost Diagnostic Model
   B. Recent Transfer Pricing Litigation
I. Part One

A. OECD BEPS 2.0 Pillar One
B. BEAT Final and Proposed Regulations
A. OECD BEPS 2.0 Pillar One
Way beyond digital: The OECD’s overhaul of the international tax rules
Work to date
2015-2019

BEPS Action 1: 2015 final report – October 2015

2018 OECD interim report – March 2018

EU Proposed Directive – March 2018
Interim Measure Digital Services Tax
Longer Term Measure Digital Permanent Establishment
The EU proposed on March 21, 2018, two directives on the taxation of the digital economy

A “longer term” solution

– a directive that would apply to intra-EU situations and situations with third countries when there is no applicable double tax treaty
  • The longer term solution would introduce the concept of the “digital permanent establishment” (DPE) and profit allocation rules and
  – a recommendation to Member States to implement such rules in their double tax treaties

An interim “targeted” solution

– a directive that would impose a 3% gross tax on payments with respect to certain digital services
  • An EU directive is proposed by the EU Commission and, in tax matters, must be approved unanimously by EU Member States before entering into force.
  • **Fails to get unanimity in EU and countries go it alone**
French digital services tax (DST)

• Signed into law July 25, 2019, by French President Emmanuel Macron, the French DST is a 3% tax on gross revenue derived by providers of certain “digital services” (online advertising, the sale of data for advertising purposes, and fees derived from linking users to online sales platforms).

• Tax was implemented in autumn 2019 and applies retroactively from January 1, 2019, to multinational companies that generate more than €750M in global digital sales and more than €25M in digital sales in France.

• US Trade Representative (USTR) Robert Lighthizer launched an investigation under Section 301 of the Trade Act of 1974.
The U.S. Trade Representative has completed the first segment of its investigation under section 301 of the Trade Act of 1974 and concluded that France’s Digital Services Tax (DST) discriminates against U.S. companies, is inconsistent with prevailing principles of international tax policy, and is unusually burdensome for affected U.S. companies… 
In addition, the French DST is inconsistent with prevailing tax principles on account of its retroactivity, its application to revenue rather than income, its extraterritorial application, and its purpose of penalizing particular U.S. technology companies.

Ambassador Robert Lighthizer said… USTR is exploring whether to open Section 301 investigations into the digital services taxes of Austria, Italy, and Turkey.
Proposed USTR remedy to Section 301 investigation conclusion
Public comments due Jan. 6, 2020

The Federal Register notice solicits comments from the public on USTR’s proposed action, which includes **additional duties of up to 100 percent on certain French products**. The notice also seeks comment on **the option of imposing fees or restrictions on French services**. The list of French products subject to potential duties includes 63 tariff subheadings with an approximate trade value of $2.4 billion.
Digital services taxes on the march

- France
- Uruguay
- Zimbabwe
- Austria
- Turkey
- Czech Republic
- Italy
- Spain
- UK
- Canada
- New Zealand
Work to date
2015-2019

OECD policy note – January 2019
- Sets out the two pillar approach

Public consultation document – February 2019
- Comments sought on policy issues and technical aspects
- Followed by public consultation meeting – March 2019

Programme of work – May 2019
- Roadmap towards agreeing consensus solution by the end of 2020

OECD Secretariat proposals – October & November 2019
- Proposed unified approach to Pillar 1 & Pillar 2
- Public consultation meetings – November & December 2019
Two “pillar” approach
Taxing the digital economy
OECD/G20 project involving 130+ countries

Agreement to examine proposals that involve two pillars in hopes of reaching consensus on new international tax rules, based in part on the view of countries that the Internet allows companies (even those that are not typically thought of as digital) to build their brand, develop an engaged customer base, and create value – even where they lack physical locations.

**Pillar 1**
Revision of the existing profit allocation and nexus rules: Realigning who gets to tax

Will require global consensus for implementation

**Pillar 2**
A global anti-base erosion proposal: Ensuring enough tax is paid somewhere

Could be implemented on a unilateral basis
Pillar One: New nexus and profit allocation rules
Unified approach proposal
## Pillar One: Three-tier mechanism
Profit allocation – beyond the arm’s-length principle

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Key features of OECD Secretariat’s proposed unified approach

Pillar One: New nexus and profit allocation rules

**New profit allocation rules**
Three tiered Formula

**Scope of New Taxing right**
Consumer facing businesses + “scale without mass” digital businesses

**New Nexus (PE) rules**
No longer based purely on physical presence
Three-tier mechanism – Amount A
New profit allocation rules

1. Determine the total profit of the group

2. Exclude “deemed” routine profit to calculate a deemed residual or excess profit.

3. Treat a percentage of deemed residual profit as attributable to market countries

4. Allocate profits between market countries using allocation keys

- Possible use of consolidated financial statements
- Consideration is being given to the use of business line and/or regional segmentation
- Fixed percentages
- Possible variation by industry
- A rough justice approach
Pillar One: Amount A nexus

Issues under discussion at OECD

1. Discussion under way to refine scope of proposal
   • Mere sales through an unrelated distributor will not alone give rise to Amount A

2. In order to subject such a business to Amount A, certain “plus” factors would have to be present before sales would give rise to Amount A:
   • The affiliated group selling already has a presence in the jurisdiction (e.g., a sales and marketing entity)
   • A company targets digital ads into a jurisdiction
   • A company licenses or franchises brands into a jurisdiction
   • A company sells digital goods or services into a jurisdiction
Three-tier mechanism – Amount B
Fixed return for baseline marketing and distribution functions

Establish a fixed return for “baseline” or routine marketing and distribution activities

Intention of OECD Secretariat to

Reduce disputes
Increase certainty
Three-tier mechanism – Amount C
Additional return based on arm’s-length transfer pricing

Provides businesses and tax authorities with the ability to **recognize profit in excess** of the return calculated under Amount B

where

the marketing and distribution activities taking place in the market country go **beyond the baseline level of functionality**

or

the group or company perform **other business activities** in the country unrelated to marketing and distribution

Any additional profit must be supported by the arm’s-length principle

- **Ensure profits are not duplicated in market country**
- **Prevent double taxation**
- **Robust measures to resolve disputes, including binding arbitration**
Pillar One: Amount A Scope
Issues under discussion at OECD

1. Companies with greater than a certain amount of revenue. (750 million euros?)
2. Consumer facing businesses
3. “Scale without mass” businesses (even if B-to-B)
4. Carve outs:
   • Extractives?
   • Financial Services (banking/insurance)
The United States supports the discussions at the OECD to address the issues faced by the international tax system.

We believe that it is very important that these talks reach agreement in order to prevent the proliferation of unilateral measures, like digital services taxes, which threaten the longstanding multilateral consensus on international taxation. The United States firmly opposes digital services taxes because they have a discriminatory impact on U.S.-based businesses and are inconsistent with the architecture of current international tax rules, which seek to tax net income rather than gross revenues.
For any new multilateral agreement to become effective, it will need to be implemented through amendments to tax treaties and/or through domestic legislation, which in turn will require broad support. Based on extensive consultations with taxpayers, we have concluded that there is broad support for greater tax certainty and administrability. However, we have serious concerns regarding potential mandatory departures from arm’s-length transfer pricing and taxable nexus standards – longstanding pillars of the international tax system upon which U.S. taxpayers rely.
Nevertheless, we believe that taxpayer concerns could be addressed and the goals of Pillar 1 could be substantially achieved **by making Pillar 1 a safe-harbor regime**. The United States also fully supports a GILTI-like Pillar 2 solution. We look forward to working with the OECD along these lines, building on the work already done.
We fully share your sense that the international tax system is under intense strain and that a global solution is needed to stop a proliferation of unilateral measures and to help us return to a stable international tax system that avoids double taxation and taxes net rather than gross income.

To a large degree, it was the US tax reform that set the framework conditions within which we have advanced. It was also your personal involvement as well as that of your delegates that steered the international community away from seeking a narrow digital solution and introduced innovative proposals into the discussions. And it was also your personal interventions at G20 meetings that moved the discussions to a broader scope using a more formulaic approach and a new nexus concept that moved us beyond the tax rules as they currently stand.
Throughout the extensive consultation process, however, we had so far not come across the notion that Pillar 1 could be a safe-harbor regime. We raise this concern, as it may impact the ability of the 135 countries that are now participating in this process, to move forward within the tight deadlines we established collectively in the Inclusive Forum.
B. BEAT Final and Proposed Regulations
BEAT Regulations – What’s New

- Exceptions for non-recognition transactions where there’s no boot
- Exceptions for pure distributions not part of an exchange
- Proposed regs: Waiver of Deductions
- Proposed rules for entering/exiting a group mid-year & short tax years
- Changes to rules for interest expense allocable to ECI under Treas. Reg. § 1.882-5 or treaty
- New partnership anti-abuse rules
No relief in Final Regulations

• No relief for intermediary payments
• No relief for global services contracts
• No relief for services provided for manufactured goods
• No netting exception
• No relief for internal dealing arrangements
• No expansion of services cost method
• No relief for GILTI/SubF/PFIC inclusions
• Pre-2018 NOLs
Some helpful stuff

- Election to waive deductions (proposed regs)
- 988 losses not BEAT payments
- Relaxation of rules for non-recognition transactions
- Members joining & leaving group
- Non-calendar year taxpayers
TP Concerns

- APAs
- Profit splits – look to character
- Cost sharing arrangements
  - Co-ownership v. deductible payments
- Internal Dealings
- Interaction with other jurisdictions
- Economics v. Formalism
- General Principles of Tax Law
  - Agency
  - Reimbursement Doctrine
  - Trust Doctrine
  - Conduit
Election to Waive Deductions

• Election to permanently forgo a deduction for all U.S. federal income tax purposes (including for BEAT)
• May be waived in whole or in part
• Deductions not waived are considered allowed for BEAT purposes, regardless of whether claimed or not on return (i.e., election to waive is the sole method for not counting as a deduction for BEAT purposes)
• Waiver can be election on original or amended return, or during exam (but can’t reverse prior election)
• Annual election
• Until proposed regs are final, make election by attaching statement to form 8991
• Election is disregarded for purposes of determining the price of a controlled transaction under section 482
• Election is disregarded for purposes of determining the price of a controlled transaction under section 482
  • in determining whether a deduction that a taxpayer reports on its Federal income tax return with respect to a controlled transaction clearly reflects the taxpayer's income with respect to the controlled transaction, the IRS will consider the amount waived as if it were actually deducted.
  • If a taxpayer applies a transfer pricing method that uses costs or expenses as an input (such as the cost plus method described in Treas. Reg. § 1.482-3(d)), the costs or expenses associated with waived deductions continue to be treated as “costs” or “expenses” for purposes of the section 482 regulations
  • This is because the waiver impacts the deductible amount only, not the amount of the underlying cost or expense
OECD Pillar Two
- Minimum tax rule and undertaxed payments rule
- Undertaxed payments rule = BEAT?
  - “Operate by way of a denial of a deduction or imposition of source-based taxation (including withholding tax) for a payment to a related party if that payment was not subject to tax at or above a minimum rate”
  - Unlike BEAT, looks to tax rate in recipient jurisdiction
- Subject to tax rule
  - To “complement the undertaxed payment rule by subjecting a payment to withholding or other taxes at source and adjusting eligibility for treaty benefits on certain items of income where the payment is not subject to tax at a minimum rate”
OECD Program of Work

• Undertaxed payments rule, under consideration:
  o The types of related party payments covered by the rule (including measures to address conduit and indirect payments);
  o The test for determining whether a payment is “undertaxed”, which will include dealing with loss situations;
  o The nature, extent and operation of the adjustment to be made under the rule (including whether it should be on the gross amount of the payment or limited to net income); and
  o The possible use and effect of carve-outs.
OECD Program of Work (continued)

• Subject to tax rule, under consideration:
  o Possible modifications to the scope or operations of treaty benefits, with priority given to interest and royalties, including:
    ▪ The limitation on the taxation of business profits of a non-resident, unless those profits are attributable to a permanent establishment
    ▪ The requirement to make a corresponding adjustment where a transfer pricing adjustment is made by the other Contracting State
I. Part Two

A. Functional Cost Diagnostic Model
B. Recent Transfer Pricing Litigation
A. Functional Cost Diagnostic Model
IRS APMA Functional Cost Diagnostic Model (FCDM)

• What is it and why should companies care?
  o Excel-based tool to assist the IRS in its analysis of whether certain intercompany transactions may be more reliably measured by applying a profit split methodology (PSM) rather than a one-sided comparable profits method (CPM)/transactional net margin method (TNMM) methodology
  o Taxpayers are asked to consider which controlled taxpayer(s) in the group incur functional costs having an economic value that would not be measured reliably by referring to benchmarks obtained from comparable uncontrolled transactions and that are expected, ex ante, to last beyond a single accounting period
Which companies are impacted?

• APMA has requested that several inbound distributors currently in the APA process complete the FCDM
• Some of the affected companies appear to have high advertising and marketing expenses
• Are B2C distributors at greater risk than B2B distributors?
Why now?

• FCDM was issued in response to APA cases, but the BEPS project did impact the thinking of the drafters
• References the 2017 OECD TP Guidelines (no references to sec. 482)
• Also consider EU Joint Transfer Pricing Forum working paper: The Application of the Profit Split Method within the EU (March 2019) (possible simplified PSM approaches)
Important APMA note re Application of FCDM

- IRS request to prepare FCDM does not imply APMA has thereby concluded already that PSM - specifically RPSM - is the “most appropriate method” for the taxpayer’s proposed covered transactions under the OECD Guidelines

- IRS APMA will make that determination based upon its review of the facts it obtains through due diligence, including discussions with the taxpayer about the application of the FCDM, and the standards set forth in the OECD Guidelines
Target RPSM Profit Computations

- Target profit for each entity in the group is computed following the steps below:

1. Construct the consolidated P&L for the group

2. For each entity, break down all costs by functions into benchmarkable or development costs
   - Benchmark returns for benchmarkable activities
   - Estimate life and lead time for all development costs centers

3. For each entity, compute the period development costs by function for the period
   - Period development costs are different than capitalized costs. Period development costs are the accounting costs incurred during the period whereas capitalized costs are the stock of costs incurred in past periods (and current period to a certain extent) that contribute to the generation of revenue in the current period
4. Determine benchmarkable profit for each function in each entity

5. Determine the consolidated gross residual profit as

\[ \text{Gross residual profit} = \text{Operating profit} + \text{development costs} - \text{benchmarked profit} \]

6. Gross residual profit is split based on the relative share of capitalized cost contributions (the sum of all the entity’s functions’ capitalized cost contributions) by entity for the period under analysis

7. For each entity, the target operating profit is an entity’s share of benchmarked profit plus its share of consolidated gross residual profit minus its development costs incurred during the period under analysis
Considerations for Applying the FCDM

• Does the FCDM prescriptively
  o either require consideration of certain factors that might not otherwise be part of a transfer pricing analysis
  o or prohibit consideration of factors that otherwise would be appropriate as part of a transfer pricing analysis?

• For example, does the FCDM
  o require segmented analyses in all cases or, conversely,
  o disregard the need to discount costs with different risk profiles in some cases?

• In short, does the FCDM allow for the flexibility that is necessary to any transfer pricing analysis in light of the idiosyncratic facts and circumstances of each unique case?
FCDM – Strategic Defensive Considerations

• How are companies responding to the concepts reflected in FCDM?
  o Evaluating “gating items” for applying FCDM?
  o Deeper comparables’ analyses (internal and external)?
  o Restructuring or modifying intercompany transactions?
  o Taking into account input from the foreign tax authorities?
B. Recent Transfer Pricing Litigation
EU State Aid

$14 B
SMBV employs 70-80 people
40-50 persons in coffee roasting
30-40 persons in logistic and administrative

9.9% net margin on operating costs excluding COGs and intangible fees

3% bean price markup until 2011 then 18% b/c of CAFÉ program branding
Starbucks obtained illegal tax advantage from the Netherlands.
Cost Pool inclusions

- costs of personnel employed for manufacturing,
- costs associated with its supply chain activities,
- costs of production equipment such as depreciation, and
- costs of plant overheads
Cost Pool exclusions

• the costs of green coffee beans (cost of raw materials),
• the logistics and distribution cost for services provided by third parties,
• the Starbucks cups, paper napkins, etc.,*
• the remuneration for activities provided by third parties under so-called “consignment manufacturing contracts”,* and
• the royalty payments to Alki LP.
Post-Decisions

Amazon

Eaton
Powering Business Worldwide
Altera US

cost sharing agreement

2004–07

Altera Cayman

IRS increases US income $80m

IRS: include employee stock options
• Treasury ignored public comments evidencing that unrelated party cost-sharing arrangements did not share stock compensation costs
• Treasury’s decision making process relied on speculation rather than on hard data and expert opinions
• Treas. Reg. § 1.482-7(d)(2) violates the arm’s length standard because no evidence that unrelated parties ever share such costs
CSA regulations 2003 are invalid under Administrative Procedure Act

- lack a “basis in fact,”
- fail to satisfy the U.S. Supreme Court’s “reasoned decision making standard” in State Farm”
- are invalid as a matter of law
Majority cites *Frank* (1962) to reverse Tax Court
• Arm’s length standard need not be based solely on comparable transactions for reallocating costs and income
• *Frank* is limited to situations difficult to hypothesize an arm’s length transaction

Dissent cites *Frank* as a corpse outlier, no longer cited
• parties in Frank stipulated to non-arm’s length standard
• “there was no evidence that arm’s-length bargaining upon the specific commodities sold had produced a higher return”
• Majority attempts to breathe life into *Frank*, create zombie
Majority distinguishes *State Farm* from *Chevron*

- *State Farm* “is used to evaluate whether a rule is procedurally defective as a result of flaws in the agency’s decision making process”
- *Chevron* “is generally used to evaluate whether the conclusion reached as a result of that process—an agency’s interpretation of a statutory provision it administers—is reasonable”
- “When Congress has ‘explicitly left a gap for an agency to fill, there is an express delegation of authority to the agency to elucidate a specific provision of the statute by regulation,’ and any ensuing regulation is binding in the courts unless procedurally defective, arbitrary or capricious in substance, or manifestly contrary to the statute.”
Majority distinguishes *State Farm* from *Chevron*

- Section 482 is ambiguous because it does not address stock based compensation cost sharing.
- Transfer of intangibles may include the transfer of future distribution rights to intangibles which stock based compensation.
- Treasury may develop methods that do not rely on analysis of ‘problematic’ comparable transactions.

*Altera Corp. v. Comm’r*, 926 F.3d 1061 (9th Cir. 2019)
What does “ANY” modify in Section 482?

Majority: expansive meaning of the statutory word “any” applies to “intangibles”
• “any” transfer . . . of intangible property

Dissent: “any” does not modify “intangible property.”
• Rather, it precedes and thus applies only to the word “transfer.”
• “any” transfer . . . of intangible property
1998 – 2004: Amazon (AmUS) cannot “simply re-launch the Amazon.com website in foreign countries”. Must launch sites that were “specifically tailored to the browsing practices, purchasing habits, [and] language and cultural preferences” of its European market.

Jan 2005: AmUS, Luxembourg-based Amazon Europe Holding Technologies (AEHT), and other Amazon subs establish cost sharing arrangement to pool resources to enhance the value of existing intangibles and to develop new intangible property.
Amazon.com v Commr, 148 T.C. 108 (2017)

- 2005: Amazon values pre-existing intangibles at $216.7 million.
- 2005 & 06: AEHT buys-in for $155.88 million
- 2005–>11: AEHT incurs R&E in excess of $1.1 billion

- 2012: IRS asserts value of $3.6 billion
- 2005: taxable income $1.04 billion
- 2006: taxable income $1.17 billion
IRS Discounted Cash Flow Method

• DCF on the projected profits of the European websites 2005 -> 2011
• Terminal Growth Rate of 3.8%
• Present Value Discount Rate 18% of projected cash flow

• Deny AmUS Deductions of $132.9 million for 2005-06
• Include AmUS $9.5 million stock-based compensation
• Cites VERITAS as controlling to reject IRS DCF method for valuation

• Best Method is CUT method with appropriate upward adjustments
IRS asserts Treas. Reg. § 1.482-4(b) includes all intangible assets of value:

- residual-business assets ...
  1. culture of innovation
  2. the value of workforce in place
  3. going concern value
  4. goodwill
  5. growth options
The definition of an “intangible” in Treas. Reg. § 1.482-4(b) of the CSA regs of 1995/1996 and 2003 amendment was *not* intended to embrace residual-business assets.
“... we must attempt to construct an arm's-length royalty.”

(Bausch & Lomb Tax Ct 1989)
• Taxpayer set up medical device mfg. in Puerto Rico, licensed in certain technology for which it paid royalties est. under CUT
  • Taxpayer asserts that CUT is the best method
  • Govt asserts that CUT is not comparable, PR mfg. is mere assembler, and CPM is the best (more reliable) method
Medtronic, Inc. v. Comm’r, 900 F.3d 610 (8th Cir. 2018)

Remand b/c factual findings insufficient to evaluate the alchemy

1. Must address in sufficient detail whether the circumstances of the settlement between Pacesetter and Medtronic U.S. were comparable to the licensing agreement between Medtronic and Medtronic Puerto Rico.

2. Must analyze the degree of comparability of the Pacesetter agreement’s contractual terms and those of the Medtronic Puerto Rico licensing agreement.

3. Must then decide the amount of risk and product liability expense that should be allocated between Medtronic U.S. and Medtronic Puerto Rico.

• The Eighth Circuit stated that determining the degree of comparability between the controlled and uncontrolled transactions requires a comparison of the significant contractual terms that could affect the results of the two transactions.
Tax Court already held APAs’ cancellation was an abuse of discretions for 2005-2006) (the Eaton II case)

IRS insisted on assessing penalties for amended returns to correct errors following APA

Tax Court holds if no Section 482 adjustment then no penalties
Pre-Decisions
Facebook US

Facebook Ireland
Rest of World ROW
2010
• user base transfer and marketing intangibles licensing agreement
• online platform intangible property buy-in-licensing agreement
• agreement to share costs and risks of online platform intangible property development
• The value of ROW new users, which are necessary to retain existing users, from that date cannot be included in the value of compensation to be paid by FIH to Facebook U.S.

• Existing users can hinder the growth of acquiring new users.

• The Online platform’s user base is an aggregation of smaller social circles because the international market is disparate by country, language, and culture.
Thank you!