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BEPS Action 8: Hard to value intangibles

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On 4 June 2015, the OECD, as part of its work on the action plan to address base erosion and profit shifting (BEPs), released a discussion draft in relation to developing an approach to price the transfer of “hard-to-value intangibles.” The draft contains an updated section of Chapter VI of the OECD *Transfer Pricing Guidelines,* including a revision of the section on arm’s length pricing when valuation is highly uncertain at the time of the transaction and adding a new section in relation to “special considerations” for hard-to-value intangibles.

As with other discussion drafts on BEPS actions, the proposals do not represent a consensus view from the G20/OECD governments involved, but are designed to provide preliminary but substantive proposals for public analysis and comment.

Arm’s length pricing when valuation is highly uncertain at the time of the transaction

When valuation of an intangible or rights in an intangible at the time of the transaction is highly uncertain, the discussion draft sets out that the arm’s length pricing question is to determine what independent enterprises would have done in comparable circumstances “to take account of the valuation uncertainty.”

The discussion draft acknowledges that, depending on the facts and circumstances, there are a number of pricing arrangements that independent parties may agree upon. In cases where subsequent developments are sufficiently predictable to make forecasts reliable, independent parties may use projections of anticipated benefits to fix a price (“ex ante” pricing) at the outset of the transaction, regardless of the eventual outcome of the benefits. In other cases, independent parties might conclude that pricing based on anticipated benefits alone does not provide adequate protection against the risks posed by the high uncertainty in valuing the intangible. In these cases, independent parties might:

- Adopt shorter term agreement;
- Include price adjustment clauses in the agreement;
- Adopt payment structures involving periodic milestone payments; for example, a royalty rate could be set to increase as the sales of the licensee increase or additional payments could be required at such time as certain development targets are successfully achieved; and/or
- Agree to renegotiate the pricing arrangement if major unforeseen

developments occur, changing the fundamental assumptions on which the pricing was determined.

The draft identifies difficulties faced by tax authorities in verifying the arm's length basis on which pricing is determined. It suggests that information asymmetry between tax authorities and businesses regarding the business and its environment may give rise to a risk of systematic mispricing.

Special considerations for hard-to-value intangibles

The discussion draft suggests that there may be a need for special considerations to be adopted when dealing with the transfer of hard-to-value intangibles. Such intangibles would include those where, at the time of their transfer between group companies, (i) no sufficiently reliable comparables exist; and (ii) there is a lack of reliable projections of future cash flows or income expected to be derived from the transferred intangible, or the assumptions used in valuing the intangible are highly uncertain.

The discussion draft also sets out features that may indicate that an intangible should be considered hard to value. These include intangibles that:

- Are only partially developed at the time of their transfer;
- Are not anticipated to be exploited commercially for several years after the transaction;
- Separately are not hard-to-value but that are connected with the development or enhancement of other intangibles that are hard-to-value; and/or
- Are anticipated to be exploited in a manner that is "novel" at the time of the transfer.

Where there is a transfer of hard-to-value intangibles, the discussion draft proposes that tax authorities may use actual results (ex post outcomes) in years subsequent to the transfer to determine whether a price adjustment is necessary. This would include assessing whether third parties would have used contingent pricing arrangements.

Where the tax authorities are able to confirm the reliability of the forecast information on which the pricing has been based, price adjustments based on actual outcomes should not be made. The discussion draft includes a specific exception to the approach suggested, whereby a review of actual outcomes should not affect pricing used by the business, if the business provides (i) full details about the forecasts used in the pricing calculation; and (ii) satisfactory evidence that any significant difference between the financial forecasts and actual outcomes was due to unforeseeable developments. Examples of unforeseeable developments include the unexpected bankruptcy of a competitor or a natural disaster occurring after the transaction.

The discussion draft suggests that these safeguards should ensure that price adjustments will apply only where the difference between expected and actual outcomes cannot be explained by considerations other than inappropriate transfer pricing.

Comments

The draft proposes a number of changes to address issues relating to hard-to-value intangibles. It falls short of taking the pragmatic approach of requiring a price adjustment clause for all transfers within a multinational group, similar to the existing US “commensurate with income” concept. Where there is a price adjustment clause in an intercompany contract, it is essential that businesses are provided with symmetry of treatment, i.e. that both the upward and downward price adjustments are respected for tax purposes. In particular, such symmetry of treatment should be available without requiring a mutual agreement procedure claim in all cases. The discussion draft does not make reference to symmetry of treatment, and businesses will be rightly concerned at the potential for a one-sided approach resulting in dispute or double taxation.

The discussion draft builds on existing guidance in the OECD’s transfer pricing guidelines. It suggests that the starting point will be the arm’s length principle, but that, in some cases, there will be a need for special considerations (a new term set out in the December 2014 discussion draft on risk, recharacterization and special measures). The special considerations will include adjustments for actual results, using hindsight, where changes from forecasts are not linked to identifiable external factors. There will be challenges in determining when the arm’s length principle will continue to apply and when the special considerations should be taken into account. This raises the potential for tax authorities to disagree over the use of special considerations and hindsight. This could be difficult, for example, if evidence of third party behavior in a specific industry suggests that a price adjustment clause would be unlikely to be concluded between third parties. In addition, the draft proposes that special considerations will not apply where tax authorities are able to “reliably assess” the information available at the time of the transfer. It remains to be seen whether both (or all) tax authorities reviewing the same transaction will share views of whether information can be reliably assessed.

The discussion draft sets out some helpful features (see below) of hard-to-value intangibles where special considerations may be required, but these fall short of a definition. To allow businesses to comply with the guidance, and to prevent disputes and potential double taxation arising from different tax authority interpretations, it is important that these features are strengthened so that they take the form of a definition.

The discussion draft asks some specific questions of business as part of the consultation process, and the first of these acknowledges the uncertainty that these proposals will create. It is essential that businesses and stakeholders comment on this draft, despite the extremely tight timetable (comments are requested by 18 June 2015), to ensure that the G20/OECD has appropriate feedback. There is a pragmatic solution available for tax authorities and businesses in this area (requirement of a price adjustment clause), but it needs to be clearly defined and consistently applied, with parameters for timetables and guidance on how adjustments should be calculated.

The special considerations proposed do not reflect the arm’s length principle, so if they are to be effective amendments to double tax treaties will be required (both to article 9 of the OECD model treaty and bilateral tax treaties, which could be achieved through the proposed multilateral instrument under the BEPS project).