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The new transfer pricing landscape
A practical guide to the BEPS changes

Global Transfer Pricing
November 2015

Hard-to-value intangibles

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The hard-to-value intangibles (HTVI) recommendations included in the final report on BEPS Actions 8-10 are intended to address perceived information asymmetries between tax administrations and taxpayers whereby tax administrations may lack access to information, be too reliant on "specialized knowledge, expertise, and insight" provided by the taxpayer, or be incapable of determining whether the differences between projected results used to set the transfer pricing (ex-ante) and the actual results (ex-post) were due to unforeseen developments or faulty transfer pricing.

The OECD initially considered the use of special measures that may have operated outside the arm's length principle,[1] including the recharacterization of intangible transactions and the application of other anti-abuse provisions. However, the OECD Secretariat instead adopted an approach consistent with the US commensurate with income (CWI) rules, which are deemed to be consistent with the arm's length principle. These rules are intended to encourage multinational enterprises (MNEs) to include price adjustment or other contingent pricing mechanisms in their license agreements when the value of the intangible being transferred is highly uncertain.

HTVI guidance

HTVI are defined as intangibles or rights in intangibles for which, at the time of the transaction, no reliable comparables existed, and projections of future cash flows expected to be derived from the transferred intangible or assumptions used in valuing the intangibles were highly uncertain. HTVI possess one or more of the following characteristics:

- The intangible is only partially developed at the time of the transfer.
- It is not expected to be exploited commercially until several years following the transaction.
- It is integral to the development of other hard-to-value intangibles.
- It is expected to be exploited in a novel manner, making reliable projections from past developments unavailable.
- It is transferred to an associated enterprise for a lump sum payment.
- It is used in connection with, or developed under, a cost contribution arrangement or similar arrangements.

Given these broad features, many intangibles will be included under the proposed HTVI analysis.

The new guidance uses actual financial outcomes to evaluate intangible transfers or license arrangements related to HTVI under certain conditions. It is presumed, barring unforeseen events, that the transfer pricing is not arm's length if there are material differences between the forecasts used to price the transaction and the actual results. However, taxpayers may rebut this presumption based on one of the following exemptions:

1. The taxpayer documented how the original projections were determined, including how reasonably foreseeable events and risks were considered and the probabilities assigned to those events. In addition, the taxpayer must provide reliable evidence that any significant difference between the financial projections and the actual outcome is due to unforeseeable events, or that the probability of the occurrence of foreseeable outcomes at the time of the transactions was not significantly overestimated or underestimated. An unforeseeable event is a low-probability event that could not be foreseen, such as a natural disaster.
2. The transfer of the HTVI was covered by a bilateral or multilateral advance pricing arrangement.
3. Any significant differences between the financial projections and the actual outcomes do not cause the projected compensation for the HTVI to deviate by more than 20 percent.
4. The HTVI has generated unrelated party revenues for the transferee for a five-year commercialization period, and any difference between the financial projections and the actual outcomes was less than or equal to 20 percent of the forecasts for that period.

The OECD Secretariat has stated that further implementation guidance will be provided in 2016. Specifically, taxpayers will have to wait for details on how tax authorities will re-price transactions if the safe harbors or exceptions are not met.

1. Under the arm's length principle, tax administrators evaluate the terms of inter-company transactions based on the terms that two unrelated parties would have concluded.

Current practice

As noted above, the US tax authorities have adopted in statute and regulations provisions similar to the HTVI recommendations. Section 482 of the Internal Revenue Code requires that income paid for the transfer of an intangible be commensurate with the income generated by the intangible. The CWI regulations include an objective 20 percent safe harbor (although the precise calculation is slightly different) to test the reliability of the projections used to set the price at the time of the transaction.

The regulations also provide for exceptions for unforeseeable events when the safe harbor is exceeded. When an adjustment is necessary, a periodic adjustment may be made to an already closed taxable period during a subsequent tax period. Accordingly, the entire transaction could be revalued in subsequent tax years regardless of the statute of limitations. The US cost sharing regulations use a different mechanism to come to a similar result. Thus, for US taxpayers, the adoption of the HTVI recommendations would have little additional impact.

With the exception of Germany, European tax and transfer pricing laws have not included price adjustment clauses or followed CWI standards. However, even though price adjustment clauses have not been stipulated in local law, practical experience in European countries shows that European tax authorities tend to challenge the pricing of intercompany transactions if there is a large deviation between the forecasted data and the actual outcome, based on the fact that under arm's length market conditions, independent parties would include a provision allowing review of pricing based on actual outcomes. Tax authorities often argue that price adjustment clauses are an inherent part of the arm's length standard.

> Given the proposed treatment of HTVI, it may be prudent to implement mechanisms that independent parties have historically used to account for uncertainty in valuing intangibles.

The German transfer pricing regulations mandate the use of price adjustment clauses for intangibles if no third-party comparables can be identified. If the parties do not include an arm's length price adjustment clause in their intercompany contract and cannot rebut the presumption that at the time of the transaction uncertainty existed regarding the underlying expectations by showing that third parties would not have included a price adjustment clause, a default price adjustment clause as defined in the German regulations would be applicable. A transfer pricing adjustment is then made if, within a 10- year period, a substantial deviation from the predicted profits or cash flows occurs. The German tax authorities are currently discussing internally whether the price adjustment provisions in the German regulations have to be amended to be in line with the OECD recommendations.

Implications

In countries that did not have formal rules or did not have a clearly defined safe harbor, the new rules may bring a measure of relief. Taxpayers now have more clearly defined rules concerning when tax authorities can make adjustments when outcomes differ from expectations.

To avoid ex-post adjustments, taxpayers should consider preparing detailed contemporaneous documentation to support the transfer price of their intangible transactions. Specifically, taxpayers will need to identify all likely risks related to the transferred intangibles and assign reasonable probabilities to the identified risks and events. The contemporaneous documentation would have to present sufficient current reliable evidence that any material differences between the projections and the actual profits were due to unforeseeable developments or the realization of properly identified and priced risks. The breadth and depth of the final documentation requirements are undefined and thus, it is not clear how demanding the final recommendations will be until the final implementation package is released in 2016. However, given the potential scrutiny to which intangible transactions are subject, taxpayers are encouraged to thoroughly document transactions.

Given the proposed treatment of HTVI, it may also be prudent to implement mechanisms that independent parties have historically used to account for uncertainty in valuing intangibles, such as contractual provisions to account for the effects of reasonably foreseeable developments. In situations with high uncertainty, taxpayers may want to limit the time frame of the agreement or include clearly defined price adjustment clauses that determine a new price. For example, including a clause that will adjust the price if the HTVI triggers are satisfied may be an option to consider. Care will need to be taken that the price adjustment clauses are appropriately balanced so that additional compensation is not required. When transferring intangibles that are not yet ready to be commercialized, taxpayers may also include contingent milestone payments.

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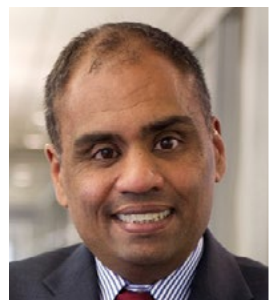

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