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Pricing of hard-to-value intangibles

The term hard-to-value intangibles (HTVI) covers intangibles or rights in intangibles for which, at the time of their transfer between associated enterprises, (i) no reliable comparables exist, and (ii) at the time the transactions was entered into, the 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, making it difficult to predict the level of ultimate success of the intangible at the time of the transfer.[1]

Transactions involving the transfer or the use of HTVI may exhibit one or more of the following features.

- The intangible is only partially developed at the time of the transfer.
- The intangible is not expected to be exploited commercially until several years following the transaction.
- The intangible does not itself fall within the definition of HTVI but is integral to the development or enhancement of other intangibles which fall within that definition of HTVI.
- The intangible is expected to be exploited in a manner that is novel at the time of the transfer and the absence of a track record of development or exploitation of similar intangibles makes projections highly uncertain.
- The intangible, meeting the definition of HTVI has been transferred to an associated enterprise for a lump sum payment.
- The intangible is either used in connection with or developed under a CCA[2] or similar arrangements.[3]

A tax administration may find it difficult to establish or verify what developments or events might be considered relevant for the pricing of a transaction involving the transfer of intangibles or rights in intangibles, and the extent to which the occurrence of such developments or events, or the direction they take, might have been foreseen or reasonably foreseeable at the time the transaction was entered into. The developments or events that might be of relevance for the valuation of an intangible are in most cases strongly connected to the business environment in which that intangible is developed or exploited. Therefore, the assessment of which developments or events are relevant and whether the occurrence and direction of such developments or events might have been foreseen or reasonably foreseeable requires specialised knowledge, expertise and insight into the business environment in which the intangible is developed or exploited. In addition, the assessments that are prudent to undertake when evaluating the transfer of intangibles or rights in intangibles in an uncontrolled transaction, may not be seen as necessary or useful for other than transfer pricing purposes by the MNE[4] group when a

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[1] OECD Transfer Pricing Guidelines, 2022, paragraph 6.189.

[2] Cost Contribution Arrangements, CCA is a contractual arrangement among business enterprises to share the contributions and risks involved in the joint development, production or the obtaining of intangibles, tangible assets or services with the understanding that such intangibles, tangible assets or services are expected to create benefits for the individual businesses of each of the participants. OECD Transfer Pricing Guidelines, 2022, paragraph 8.3.

[3] OECD Transfer Pricing Guidelines, 2022, paragraph 6.190.

[4] Multinational Enterprises

transfer takes place within the group, with the result that those assessments may not be comprehensive. For example, an enterprise may transfer intangibles at an early stage of development to an associated enterprise, set a royalty rate that does not reflect the value of the intangible at the time of the transfer, and later take the position that it was not possible at the time of the transfer to predict the subsequent success of the product with full certainty.

The difference between the ex ante and ex post value of the intangible would therefore be claimed by the taxpayer to be attributable to more favourable developments than anticipated. The general experience of tax administrations in these situations is that they may not have the specific business insights or access to the information to be able to examine the taxpayer's claim and to demonstrate that the difference between the ex ante and ex post value of the intangible is due to non-arm's length pricing assumptions made by the taxpayer. Instead, tax administrations seeking to examine the taxpayer's claim are largely dependent on the insights and information provided by that taxpayer. These situations associated with information asymmetry between taxpayers and tax administrations can give rise to transfer pricing risk.

Ex post evidence provides;

- presumptive evidence as to the existence of uncertainties at the time of the transaction,
- whether the taxpayer appropriately took into account reasonably foreseeable developments or events at the time of the transaction,
- and the reliability of the information used ex ante in determining the transfer price for the transfer of such intangibles or rights in intangibles.[5]

For such intangibles, information asymmetry between taxpayer and tax administrations, including what information the taxpayer took into account in determining the pricing of the transaction, may be acute and may exacerbate the difficulty encountered by tax administrations in verifying the arm's length basis on which pricing was determined for the reasons discussed above.

As a result, it will prove difficult for a tax administration to perform a risk assessment for transfer pricing purposes, to evaluate the reliability of the information on which pricing has been based by the taxpayer, or to consider whether the intangible or rights in intangibles have been transferred at undervalue or overvalue compared to the arm's length price, until ex post outcomes are known in years subsequent to the transfer. [6]

In these circumstances, the tax administration can consider ex post outcomes as presumptive evidence about the appropriateness of the ex ante pricing arrangements. However, the consideration of ex post evidence should be based on a determination that such evidence is necessary to be taken into account to assess the reliability of the information on which ex ante pricing has been based. Where the tax administration is able to confirm the reliability of the information on which ex ante pricing has been based, notwithstanding the approaches, then adjustments based on ex post profit levels should not be made.

[5] OECD Transfer Pricing Guidelines, 2022, paragraph 6.188.

[6] OECD Transfer Pricing Guidelines, 2022, paragraph 6.191.

In the action 8 of BEPS published in June 2018, various examples are given in the "Guidance for Tax Administrations on the Application of the Approach to Hard-to-Value Intangibles".

Example:

Company A, a resident of Country A, has patented a pharmaceutical compound. Company A has concluded pre-clinical tests for the compound and has successfully taken the compound through Phases I and II of the clinical trials. Company A transfers in Year 0 the patent rights to an affiliate, Company S, a resident of Country S. Company S will be responsible for the Phase III trials following the transfer. In order to determine the price for the patent on the partially developed drug, the parties made an estimation of expected income or cash flows that will be obtained upon exploitation of the drug once finalised over the remaining life of the patent. Assume the price so derived at the time of the transfer was 700 and that this was paid as a lump sum in Year 0.

In particular, the taxpayer assumed sales would not exceed 1,000 a year and that commercialisation would not commence until Year 6. The discount rate was determined by referring to external data analysing the risk of failure for drugs in a similar therapeutic category at the same stage of development. Even if the tax administration of Country A had been aware of these facts relating to the transfer of the patent rights in Year 0, it would have had little means of verifying the reasonableness of the taxpayer’s assumptions relating to sales.

Scenario A

In Year 4, the tax administration of Country A audits Company A for Years 0-2 and obtains information that commercialisation in fact started during Year 3 since the Phase III trials were completed earlier than projected. Sales in Years 3 and 4 correspond to sales that were projected, at the time of the transfer, to be achieved in Years 6 and 7. The taxpayer cannot demonstrate that its original valuation took into account the possibility that sales would arise in earlier periods, and cannot demonstrate that such a development was unforeseeable.

The tax administration uses the presumptive evidence provided by the ex post outcome to determine that the valuation made at the time the transaction took place did not consider the possibility of sales occurring in earlier years. The taxpayer's original valuation is revised to include the appropriately risk-adjusted possibility of earlier sales resulting in a revised net present value of the drug in Year 0 of 1,000 instead of 700. The revised net present value also takes into account the functions performed, assets used and risks assumed in relation to the HTVI by each of the parties before the transaction and reasonably anticipated, at the time of the transaction, to be performed, used or assumed by each of the parties after the transaction. Therefore, assume for the purposes of the example that the arm's length price anticipated in Year 0 should have been 1,000. Note that the value of 1,000 is not necessarily the net present value of the transferred rights based solely on the actual outcome.

In accordance with the approach to HTVI, the tax administration is entitled to make an adjustment to assess the additional profits of 300 in Year 0.

Scenario B

The tax administration uses the presumptive evidence provided by the ex post outcomes to determine that the valuation made at the time the transaction took place, did not consider the possibility of sales occurring in earlier years. The taxpayer's original valuation is revised to include the appropriately risk-adjusted possibility of sales occurring in earlier years resulting in a revised net present value of the drug in Year 0 of 800 instead of 700. Therefore, assume for the purposes of the example that the arm's length price anticipated in Year 0 should have been 800. Note that the value of 800 is not necessarily the net present value of the transferred rights based solely on the actual outcome.

In accordance with the approach to HTVI, the tax administration is entitled to make an adjustment to assess the additional profits of 100 in Year 0. However, in this example, the exemption provided by item (iii) applies since the adjustment to the compensation for the transfer is within 20% of the compensation determined at the time of the transaction.

Depending on the facts and circumstances of the case a multi-year analysis of the information for the application of this approach may be appropriate.

This approach will not apply to transactions involving the transfer or use of HTVI, when at least one of the following exemptions applies.

i. The taxpayer provides:
   1. Details of the ex ante projections used at the time of the transfer to determine the pricing arrangements, including how risks were accounted for in calculations to determine the price (e.g. probability-weighted), and the appropriateness of its consideration of reasonably foreseeable events and other risks, and the probability of occurrence; and,
   2. Reliable evidence that any significant difference between the financial projections and actual outcomes is due to;
      a. Unforeseeable developments or events occurring after the determination of the price that could not have been anticipated by the associatedenterprises at the time of the transaction; or
      b. The playing out of probability of occurrence of foreseeable outcomes, and that these probabilities were not significantly overestimated or underestimated at the time of the transaction.

ii. The transfer of the HTVI is covered by a bilateral or multilateral advance pricing arrangement in effect for the period in question between the jurisdictions of the transferee and the transferor.

iii. Any significant difference between the financial projections and actual outcomes mentioned in i)2 above does not have the effect of reducing or increasing the compensation for the HTVI by more than 20% of the compensation determined at the time of the transaction.

iv. Year in which the HTVI first generated unrelated party revenues for the transferee and in which commercialisation period any significant difference between the financial projections and actual outcomes mentioned in i)2 above was not greater than 20% of the projections for that period.[7]

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[7] OECD Transfer Pricing Guidelines, 2022, paragraph 6.193.

The first exemption means that, although the ex post evidence about financial outcomes provides relevant information for tax administrations to consider the appropriateness of the ex ante pricing arrangements, in circumstances where the taxpayer can satisfactorily demonstrate what was foreseeable at the time of the transaction and reflected in the pricing assumptions, and that the developments leading to the difference between projections and outcomes arose from unforeseeable events, tax administrations will not be entitled to make adjustments to the ex ante pricing arrangements based on ex post outcomes. For example, if the evidence of financial outcomes shows that sales of products exploiting the transferred intangible reached 1,000 a year, but the ex ante pricing arrangements were based on projections that considered sales reaching a maximum of only 100 a year, then the tax administration should consider the reasons for sales reaching such higher volumes. If the higher volumes were due to, for example, an exponentially higher demand for the products incorporating the intangible caused by a natural disaster or some other unexpected event that was clearly unforeseeable at the time of the transaction or appropriately given a very low probability of occurrence, then the ex ante pricing should be recognised as being at arm's length, unless there is evidence other than the ex post financial outcomes indicating that price setting did not take place on an arm's length basis.[8]

Summary

In summary, the differences between ex ante and ex post results during pricing of hard-to-value intangibles and the information asymmetry between taxpayer and tax administration cause transfer pricing risk. In order to prevent this, intangible assets that are difficult to value will be evaluated as ex ante and ex post, and transfer pricing analyzes will be made based on ex ante projections. However, if there are exceptions between the ex ante and ex post values, the company may make changes in the transfer pricing analysis based on the ex ante values.

[8] OECD Transfer Pricing Guidelines, 2022, paragraph 6.194.