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How Should Hard-to-Value Intangibles be Priced?

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What is a Hard-to-Value Intangible?

- Guidance on Hard-to-Value Intangibles (HTVI) can be found in Section D.4, paragraphs 6.186-6.195 of the 2017 OECD Transfer Pricing Guidelines.
- The kind of transfer pricing abuse which is envisaged is described in paragraph 6.186 – this would include the transfer of intangibles within a group at an early stage of development for a fixed price, or in return for a fixed ongoing royalty, which subsequently appears to be a serious undervaluation.
- In such situations it is often difficult for a tax administration to establish the truth of the matter because it does not have the taxpayer's business insights and information sufficient to establish whether the subsequent profitability of the intangibles could have been reasonably foreseen at the time of the transfer.
- Specialist knowledge, expertise and insight is required about the business environment in which the intangible is developed or exploited.
- Moreover, the company may not have applied this knowledge, expertise and insights (which might subsequently become available to a tax administration) in a comprehensive assessment at the time of the transfer.
- However, as noted in paragraph 6.187, the tax administration can at least expect to receive the projections that were made at the time of the transfer and compare them with the outturn. A wide deviation may then be the starting point for a review of the extent to which the outturn results were reasonably foreseeable at the time of the transfer (with the potential conclusion that a different transfer price should have been agreed).

What is a Hard-to-Value Intangible? (continued)

- Paragraph 6.188 refines this analysis by introducing the concept of the weights which should have been applied to different foreseeable outcomes.
- It also introduces the possibility of challenging the reliability of the information used to determine the value of the intangible.
- In paragraph 6.189, a more specific definition of HTVI is provided, namely ones for which:
  - no reliable comparables existed; and
  - future projections would have been highly uncertain.
- Paragraph 6.190 drills down even further, listing the following potential features of HTVI at the time of the transaction:
  - only partially developed;
  - not expected to be exploited commercially until several years after the transaction;
  - if not itself a HTVI, is integral to the development or enhancement of a HTVI;
  - is expected to be exploited in a novel manner;
  - is transferred for a lump sum; and/or
  - is either used in connection with, or developed under, a cost contribution arrangement.
- As noted in paragraph 6.191, the possibility of a transfer at undervalue may not become apparent until some years later.

How Might Arm's Length Parties Structure an Agreement for the Transfer of a Hard-to-Value Intangible?

- Paragraph 6.192 introduces the possible alternative payment arrangements that might be imputed by a tax administration, including contingent pricing arrangements.
- Paragraph 6.192 refers back to paragraph 6.185 which states that a tax administration may impute a mechanism which independent parties would have agreed to in order to address high uncertainty in valuing an intangible:
  - one such mechanism could be a price adjustment clause;
  - another is a price renegotiation clause.
- Footnote 8 (to paragraph 6.193) notes that in some business sectors it is not unusual for an intangible to be transferred with a contingent clause relating to a second (or further) use.
- Looking further back, paragraph 6.183 (dealing with highly uncertain valuation) notes that contingent pricing arrangements could include payments linked to certain events, such as:
  - the achievement of predetermined financial thresholds such as sales or profits; or
  - the achievement of predetermined development stages.
- Thus a royalty could be set to increase as the sales of the licensee increase.
- Paragraph 6.184 also speaks of renegotiations being triggered by the unexpected development of an alternative low cost product.

Implications for Transfer Pricing Compliance

- How can challenges to earlier HTVI valuations be addressed?
  - provide evidence of the robustness and completeness of the projections made, including the information used and the weights applied;
  - provide evidence that, for the different foreseeable outcomes, the degree of certainty of the projections meant that no additional contingent payments would have been agreed to by independent parties; and/or
  - identify events which have affected outturns and which could not have been reasonably foreseen.
- How can a new HTVI valuation be made more challenge-proof?
  - gather sufficient, reliable information;
  - identify the reasonably foreseeable outcomes and weight them in a sound manner;
  - if there is significant uncertainty as to potential outcomes and/or their relative probabilities, include contingent payments and/or negotiation clauses as appropriate; and
  - note the types of event which could affect outcomes significantly but which cannot be foreseen with sufficient certainty to be included in the projections.

How Should Hard-to-Value Intangibles be Valued?

- By definition, the Comparable Uncontrolled Price Method cannot be used to value HTVI because paragraph 6.189 defines them as ones for which no reliable comparables exist.
- Paragraph 6.150 notes that a profit split analysis might be used for transfers of partially developed intangibles.
- In such an approach, the transferor's financial contribution to the partially developed intangible may be amortised over the useful life of the intangible, assuming no further development, and compared with the acquirer's further contribution.
- However, paragraph 6.151 warns that the contribution or value of work undertaken prior to the transfer may bear no relationship to the cost of that work. In such a valuation approach the following factors would have to be taken into account:
  - the relative importance of all the work in the development process (e.g. the discovery of the chemical compound at the heart of a blockbuster drug);
  - the degree of risk attached to the work at each stage of development;
  - the appropriate amortisation rate at each stage of development;
  - the assumption about the time at which revenues will arise; and
  - the value of contributions other than intangibles to the generation of the profit.

How Should Hard-to-Value Intangibles be Valued? (continued)

- Given the need to make so many assumptions, paragraph 6.151 casts doubt on the usefulness of the Profit Split Method to value intangibles.
- Section D.2.6.3 discusses the use of “valuation techniques” (as part of, or as opposed to, one of the five OECD transfer pricing methods). Paragraph 6.153 notes that this is acceptable where no reliable comparable uncontrolled transaction can be identified (as will be the case with HTVI).
- In particular, paragraph 6.153 points to the “particular usefulness” of income-based valuation techniques, especially ones involving the calculation of the discounted value of projected future income streams or cash flows
- Paragraph 6.155 warns that valuations performed for accounting purposes (especially purchase price allocations) may reflect overly-conservative assumptions and therefore under-value intangible assets.

How Should Hard-to-Value Intangibles be Valued? (continued)

- Paragraph 6.157 notes that valuations involving the estimation of discounted cash flows require assumptions about the following inputs:
  - realistic and reliable financial projections;
  - growth rates;
  - discount rates;
  - the useful life of the intangible
  - taxes on future revenue, tax amortisation benefits available to the acquirer and taxes on the sale proceeds; and
  - terminal values (where appropriate) - that is, ongoing contributions to revenue after the forecasting period.

How Should Hard-to-Value Intangibles be Valued? (continued)

- Paragraph 6.157 also guides that this calculation should be made separately from the perspective of both parties (for example, with different discount rates and tax effects).
- The expectation is then that the arm's length price will fall somewhere between these two valuations (presumably by taking into account the relative competitive position of the buyer and seller - see paragraph 1.110).
- The concept of "relative competitive positions" is not developed in the Transfer Pricing Guidelines, but in the UK *DSG* case it was considered at length by a competition economist. Relevant EU Directives and competition law now seems to be the best source of information for how to apply the concept.
- Paragraph 6.157 directs us to the illustrative examples 27 to 29 in the Annex to Chapter VI. Here, in example 29 (at paragraph 108) we are guided to identify the maximum net present value which the seller could achieve if it were not to sell the intangible, and the maximum net present value which the purchaser could achieve by gaining access to a similar intangible in another way.
- These figures represent the other options realistically available and also set boundaries to the valuation.

How Should Hard-to-Value Intangibles be Valued? (continued)

- Section B.2 (paragraphs 9.24-9.26) discusses the expected synergies arising from the transfer and centralisation of intangibles. Paragraph 9.24 warns that where synergies are the result of deliberate, concerted group actions, the entities included should be remunerated appropriately. In order to confirm that the taxpayer has done this, it is good practice for the taxpayer to document the following:
  - what the anticipated synergies are;
  - on what assumptions they are anticipated;
  - the source of the synergies; and
  - how they will impact at the entity level.

How Should Hard-to-Value Intangibles be Valued? (continued)

- Paragraph 6.160 states that it is good practice for taxpayers relying on valuation techniques to present a sensitivity analysis showing the effect of alternative assumptions about the input values.
- Paragraph 6.161 warns that assumptions used in valuations should be the same as in non-tax projections – useful life assumptions are mentioned as a specific example.
- Paragraph 6.175 notes that the useful life of an intangible will be influenced by:
  - the nature and duration of the legal protections;
  - the rate of technological change in the industry; and
  - the extent of competition.
- Paragraph 6.171 warns against the use of a single discount rate (such as the weighted average cost of capital) in every valuation. Paragraph 6.172 recommends consideration of a higher discount rate for research and development expense than for the resulting revenues (to reflect the different risk).

Conclusions

- Hard-to-Value Intangibles require special attention by taxpayers. They include intangibles which are only partially developed or which need to be exploited in a novel way.
- Techniques are available for responding to, and avoiding controversy in this area, such as making and weighting a range of forecasts, and noting the key events which could affect them but which have not been included.
- In particular, the terms of HTVI transfer agreements merit careful attention from lawyers and transfer pricing economists. Price adjustment and renegotiation clauses should be considered.
- Transfer pricing economists should be included in HTVI valuations, making careful reference to the detailed guidance that is now included in the Transfer Pricing Guidelines. In particular:
  - specialist valuation methods are likely to be most appropriate, especially income-based ones;
  - valuations should be made from the perspective of both parties;
  - valuations must be at least as high as the highest realistic alternative for both parties; and
  - a price in the arm's length range must be determined on the basis of the relative competitive position of the parties.

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Prior to joining Duff & Phelps, Danny was global head of transfer pricing economics at Freshfields Bruckhaus Deringer and before that was partner and global head of transfer pricing at Grant Thornton. He began his career as an international management consultant and then transfer pricing specialist at Ernst & Young. His past work includes: a successful expert report to settle a guarantee fee dispute; securing the first UK construction industry APA; the successful presentation of a transfer pricing report to resolve a VAT dispute; defence assistance in transfer pricing audits across Europe and Asia-Pacific; and transfer pricing planning and benchmarking of profit margins, royalty rates, interest rates, guarantee fees, and other fees and commissions.

Danny has been listed in Euromoney's "Guide to the World's Leading Transfer Pricing Advisers" and "World's Leading Tax Controversy Advisers" as well as Chambers Tax.

Danny has a PhD in economics from Queen Mary College London, where he now lectures on transfer pricing, as he has also lectured at Kings College and the London School of Economics. He has been a member of the CBI International Tax Working Group and the CIOT Dispute Resolution Working Group, as well as HMRC's Transfer Pricing and Thin Cap Interest Groups. Danny is the Editor-in-Chief of the Bloomberg BNA journal Transfer Pricing Forum.

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