

## TAX FLASH NEWS

### OECD releases discussion draft on hard-to-value intangibles under Action 8 of the OECD/G20 BEPS Action Plan (Discussion Draft)

The Guidance on Transfer Pricing Aspects of Intangibles, issued in September 2014 retained the current language in the 2010 version of the Organisation for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines relating to aspects of hard-to-value intangibles in Section D.3. However, that guidance was bracketed and shaded to indicate its status as interim guidance, given the close interaction with the work to be done in 2015.

This Discussion Draft responds to the requirement under Action 8 of the OECD/G20 Base Erosion and Profit Shifting (BEPS) Action Plan to develop an approach to hard-to-value intangibles and proposes to revise the existing guidance Section D.3 of the Guidance on Transfer Pricing Aspects of Intangibles i.e. Chapter VI of OECD Transfer Pricing Guidelines.

The Discussion Draft explains the difficulties faced by tax administrations in verifying the arm's length basis on which pricing was determined by taxpayers for transactions involving a specific category of intangibles i.e. hard-to-value intangibles (HTVI).

When valuation of an intangible or rights in an intangible at the time of the transaction is highly uncertain, the question arises as to how arm's length pricing should be determined. The Discussion Draft suggests that the question should be resolved, both by taxpayers and tax administrations, by reference to what independent enterprises would have done in comparable circumstances to take account of the valuation uncertainty in the pricing of the transaction.

The Discussion Draft includes an approach based on the determination of the arm's length pricing arrangements, including any contingent pricing arrangements that would have been made between independent enterprises at the time of the transaction. It specifies conditions that are to be met before the tax administrations can make a pricing adjustment to transactions involving transfer of intangibles or rights in intangibles.

The general experience of tax administrations is that they do 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 (estimated) and ex post (actual) value of the intangible is due to mispricing by the taxpayer. Instead, tax administrations seeking to examine the taxpayer's claim are largely dependent on the insights and information provided by the taxpayer himself. These situations can give rise to a risk of systematic mispricing.

For example, an enterprise may transfer intangibles at an early stage of development to an associated enterprise and 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 that were not anticipated.

The term HTVI has been explained to cover intangibles or rights in intangibles for which, at the time of their transfer in a transaction between associated enterprises:

- No sufficiently reliable comparables exist, and
- There is a lack of reliable projections of future cashflows or income expected to be derived from the transferred intangible, or the assumptions used in valuing the intangible are highly uncertain.

As a consequence, ex post information provides presumptive evidence as to the reliability of the information used ex ante in determining the transfer price for the transfer of such intangibles or rights in intangibles.

The Discussion Draft states that HTVI may exhibit one or more of the following features:

- Intangibles that are only partially developed at the time of the transfer;
- Intangibles that are not anticipated to be exploited commercially until several years following the transaction;
- Intangibles that separately are not HTVI but which are connected with the development or enhancement of other intangibles which fall within the category of HTVI;
- Intangibles that are anticipated to be exploited in a manner that is novel at the time of the transfer.

For such intangibles, information asymmetry between the taxpayer and tax administrations may be acute and may aggravate the difficulty encountered by tax administrations in verifying the arm's length basis on which pricing was determined.

In evaluating the ex ante pricing arrangements, the tax administration is entitled to use the ex post evidence about financial outcomes to inform the determination of the arm's length pricing arrangements, including any contingent pricing arrangements, that would have been made between independent enterprises at the time of the transaction. A contingent pricing arrangement is any pricing arrangement in which the quantum or timing of payments or renegotiation provisions are dependent on contingent events, including the achievement of predetermined financial thresholds such as sales or profits, or of predetermined development stages.

The pricing adjustments may be made to the value of intangibles or rights in intangibles in case of HTVI, except where the taxpayer:

- Provides full details of its 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 comprehensiveness of its consideration of reasonably foreseeable events and other risks; and
- Provides satisfactory evidence that any significant difference between the financial projections and actual outcomes is due to unforeseeable or extraordinary developments or events occurring after the determination of the price that could not have been anticipated by the associated enterprises at the time of the transaction.

As a result, 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, and that the developments leading to the difference between projections and outcomes arose from unforeseeable events, no adjustment to the ex ante pricing arrangements based on these special considerations would be justified.

For example, if the evidence of financial outcomes shows that sales of products exploiting the transferred intangible reached 1000 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 high volumes (i.e. 1000 a year). 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 the unexpected bankruptcy of a competitor that was clearly unforeseen at the time of the transaction, then the ex ante pricing should be recognised as being at arm's length.

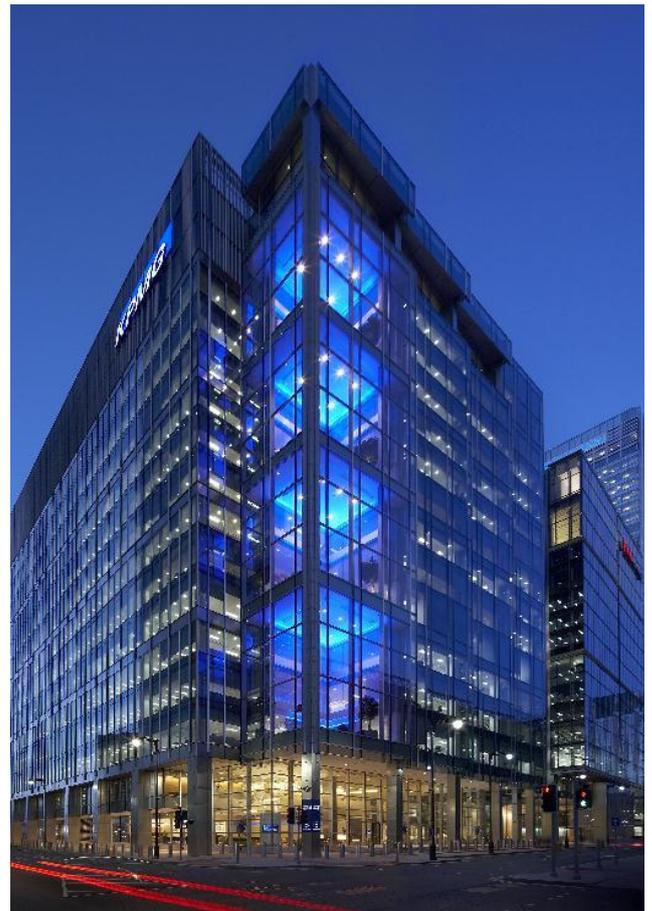
## Our comments

The Discussion Draft states that situations where there is a significant difference between ex-ante and ex-post value of intangibles due to unforeseeable circumstances or uncertainties should be distinguished from situations in which hindsight is used by associated enterprises inappropriately by not taking into consideration such information that could have affected the ultimate price of the intangibles. In situations where it was not possible to foresee uncertainties, the tax administration should not make a pricing adjustment.

It may however be necessary to clearly explain what would be considered as a significant difference e.g. if the difference between the ex-ante value and ex-post value of an intangible is more than 50 per cent of the ex-ante price, the difference may be considered as significant. Further, it may be difficult for tax administrations to determine the genuineness of the nature of events which lead to fluctuation in the value of intangibles i.e. whether they were anticipated or unforeseen. Therefore, it may be important to provide more insight and examples in the guidance to distinguish between situations where pricing adjustment is called for and where not.

Further, there may be a provision where projections are used to value intangibles, that projections may be relooked at and updated based on actuals at regular intervals and the pricing adjustment may be suo-moto offered by the taxpayers.

One can therefore presume that it is of utmost importance to maintain robust and detailed documentation supporting the valuation of intangibles at the time of their transfer, which can enable taxpayers to justify that they had taken into consideration all the relevant factors that existed at the time of transfer and any significant fluctuation in the value of intangibles ought to be attributed to unforeseen factors.



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