Germany

A practical solution for hard to value intangibles

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It is likely that many tax disputes will arise from the new definition of hard to value intangibles (HTVI) in the OECD's Transfer Pricing (TP) guidelines.

The key point of the new guidance is that a transfer of intangibles within a multinational group will often have to be revalued based on data years after the original transfer. This approach creates many problems and has been criticised as a departure from the arm's-length principle.

Hard to value intangibles

The OECD defines HTVI's as intangibles that fulfil two criteria:

1) There is no reliable comparable; and
2) At the time of the transaction, the projected future income associated with the intangible is uncertain.

Unfortunately, this is true for nearly all intangibles, since intangibles are by definition unique. After-all, they are what sets a successful company apart from its competition, so one can rarely identify a transaction between independent parties where almost an identical intangible is transferred.

Furthermore, future incomes are always uncertain, but especially so for intangibles that in most TP systems receive a volatile residual profit.

Nevertheless, the OECD has clear reasons for imposing the HTVI concept to intra-group intangible transfers in the tax regulatory environment.

It is a response from tax authorities where potentially intellectual property (IP) of high value is transferred to low-tax jurisdictions at an early stage of development for very low buy-out values. This low valuation is often based on development costs plus a modest profit mark-up, assuming that no realistic profit expectations could be estimated reliably at an early stage, in addition to there being a high risk of failure at later stages of development.

The OECD guidelines tackle this in two ways:

1) They reject cost-based valuations in favour of the discounted cash flow method, despite uncertainties prevailing at this stage of transfer; and
2) More critically, they prescribe to validate forecasts through ex-post actuals. If there is a significant difference, tax authorities are entitled to impose adjustments based on the actuals, even if the transacting parties have not agreed on price adjustments clauses.

Arms-length principle

While the request to consider the future profit potential seems justified, the request to impose retroactive price adjustments is a significant departure from the arm's-length principle.

Between third parties, ex-post adjustments of up to 10 years after a transaction are very rare as both parties typically agree than an asset is transferred with all risks. This is for good reason: actual profits often deviate strongly from initial expectations, which can result in extremely large and unforeseeable adjustment payments, years after a transaction. This is obviously difficult to accommodate from accounting, tax and organisational perspectives.

Ex-ante uncertainties

Multinationals that do not want the valuation of their transactions to be open for ex-post adjustments must therefore provide evidence that they have properly considered ex-ante uncertainties. When these uncertainties are reflected in the original valuation, ex-post adjustment should simply not be justified, since deviations were then already accounted for.

One method to reflect the uncertainties and improve ex-ante valuations are scenario building techniques that go way beyond vanilla discount cash-flows.

Methods that NERA has successfully deployed to consider the specific risks related to the development of HTVI include real option pricing, which is supported by Monte Carlo simulations, and the binomial tree analysis.

All these methods are based on not just assuming a single prediction of a future income, but explicitly looking at different scenarios, which range from failure to better-than-expected.

Case study

As an example, we had valued a software program in development stage that was transferred between German and Irish entities based on five different scenarios. These scenarios were based on the actual business development plan regarding potential future software features and associated business strategies.

Now, several years later, it looks like the software will be successful. However, under a normal cash-flow valuation, the original buy-out would need to have been adjusted significantly. However, since very positive development was explicitly accounted for and incorporated into the valuation, there is no need for further adjustments, even in the new HTVI framework.

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