How to Deal with Risks in the Context of Two-Sided IP Valuations after BEPS?

The authors analyse the impact of BEPS Actions 8-10 (aligning transfer pricing outcomes with value creation) on the remuneration of intellectual property (IP) for MNEs. They especially analyse the OECD’s approach of bilateral IP valuations and how to handle risks when conducting such a valuation.

1. BEPS, the Valuation of Intangibles and the Impact of Risks: An Introduction

The focus of the OECD BEPS Project is mainly on substance, transparency and coherence, which are identified weaknesses of international tax regulations. To remedy the resulting double or non-taxation, the OECD decided in 2013 to develop a 13-point Action Plan on Base Erosion and Profit Shifting (BEPS).

The BEPS Project especially affects MNEs’ intercompany remuneration systems, as a consensus of Actions 8-10 on transfer pricing outcomes and value creation resulted in the two-sided valuation of intangibles. A separate final report was issued focussing on IP remuneration. The results were then included in the revised OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines) 2017.

Because of the principles of the Actions 8-10 Final Report, MNEs are faced with increased administrative burdens, for example, conducting an analysis of existing contracts and of transfer pricing structures between related companies, whilst taking into account the BEPS Action Points for IP remuneration for all actions resulting from the analyses. A review of the value chain and essential success factors of the MNE seems indispensable, which should also take the so-called development, enhancement, maintenance, protection and exploitation (DEMPE) criteria into consideration, as well as the implementation of the changes into the company’s transfer pricing principles.

Especially the ownership and remuneration of IP is crucial when it comes to the application of the revised arm’s length transfer pricing standards. The determination and bilateral valuation of a transfer price at arm’s length (transactional value) frequently meets high uncertainty due to insufficiently predictable risks or non-existing comparables.

In sections 2. and 3., the bilateral valuation methodology of IP with special consideration of the related risks will be examined. The focus will in particular be on the so-called “hard to value intangibles” (HTVIs). Other critical aspects of the valuation of IP that will be further analysed are price adjustment clauses, potential renegotiations and contingent payments that are required by the OECD in certain situations.

2. Bilateral Valuation Methodology as Best Practice for Intangibles?

2.1. Principles

With the 2017 Guidelines, the OECD has introduced a bilateral valuation approach applicable to IP in section 6.157:

... depending on the facts and circumstances of the individual case, the calculation of the discounted value of projected cash flows derived from the exploitation of the intangible should be evaluated from the perspectives of both parties to the transaction in arriving at an arm’s length price.

The basis for such a valuation is a DEMPE-based functional analysis taking into account the functions performed, risks assumed and assets used by each party. The 2010 OECD Guidelines could be interpreted that way already but did not mention this valuation methodology in such an explicit form.

From a GAAP perspective, bilateral “subjective” valuation approaches are established concepts, for example, the German Einigungs- und Grenzwertbetrachtung (agreed and threshold value approach), although, in practice, one-sided “objective” approaches are more often applied.

From a German tax perspective, bilateral (transfer pricing) approaches have a long history before the Federal Finance Court, where the principle of “two prudent and conser-
entious business managers” was established. This principle became legislation in 2008 with the hypothetical CUP method of section 1, paragraph 3 of the Aussensteuergesetz (Foreign Tax Act, AStG). As supplement to section 1, paragraph 3 of the AStG, the German ordinance on the transfer of functions, Funktionsverlagerungsverordnung, was also introduced in 2008, handling the application of the hypothetical CUP method with respect to the transfer of functions and corresponding (im)material assets. The ordinance on the transfer of functions could have served as a model for the OECD’s first draft of a BEPS Action 8 report “Guidance on Transfer pricing aspects of intangibles”. In a first attempt, the hypothetical CUP was introduced by the OECD in an elaborate example of a 2012 pre-BEPS draft regarding special considerations for intangibles. Although the example did not make it to the final guidelines for intangibles, the two-sided valuation approach is now well established within the latest version of the OECD Guidelines. So it can be concluded that the German tax authorities recognized the issues of base erosion and profit shifting rather early and acted accordingly. After nearly 10 years of having a special regulation when it comes to the transfer of IP, a bilateral valuation approach may now be considered as the best practice for IP, not only in Germany, but also on the OECD level.

2.2. Valuation object: Intangible assets

Generally, the term “intangible assets” is very broadly defined by the OECD Guidelines (2017). It is explicitly discouraged to use available GAAP and other non-OECD definitions for tax purposes. Types of intangibles according to the OECD include: patents, know-how and trade secrets, trademarks, trade names and brands, rights under contracts and government licences, licences and similar rights in intangibles, and goodwill. In contrast, synergies and location savings are not considered IP because they cannot be owned or controlled by a party. Nevertheless, they may be considered in the valuation process of the intangible (for example, when cash flows and discount rates are being assessed).

Furthermore, separate transferability is no requirement for the classification as IP. In fact, an aggregate analysis of all IP involved, functions and risks needs to be performed to identify the valuation object. In practice, this will lead to more cases where the valuation object consists of a group of material and immaterial assets that will be analysed together as a package. This is a very similar approach as that set forth in the German ordinance on the transfer of functions. Further, it will be hard under the OECD Guidelines (2017) to separate a transfer of IP from a business restructuring, since they intersect.

The determination of arm’s length transfer prices in the case of a transfer of such a package leads to the question which transfer pricing method should be applied.

2.3. Selection of the appropriate transfer pricing method

Basically, the OECD still allows a free selection of the transfer pricing method between the CUP-method (i.e., market approach), the cost approach and the income approach. Practically, (discounted net) income-based valuations for transfer pricing purposes are usually conducted for intangibles because reliable prices and comparables are barely available. Further the OECD requirements regarding database analyses are rather stringent. Cost approaches are only allowed in exceptional cases by the OECD. In the selection of the most appropriate transfer pricing method, attention should be given to (i) the nature of the relevant intangibles, (ii) the difficulty of identifying comparable uncontrolled transactions and (iii) the difficulty of applying the transfer pricing methods involving the transfer of intangibles. The actually applied method (for example, relief from royalty, multi-period excess earnings method, residual value) is not prescribed. Again, potentially available valuations for accounting purposes, and especially for purchase price allocations, are principally rejected. As a result, an income-based valuation of intangibles will lead to an outcome that should be accepted by most tax authorities. The application of an income-based valuation method will lead to other questions though, which will be discussed in sections 2.4.-2.6.

2.4. When are bilateral valuation methods applicable?

The Final Report on Action 8 expounds in section 6.139 that in cases where no reliable comparable uncontrolled transactions can be identified, the arm’s length principle demands the use of another method in order to ensure that uncontrolled parties would have determined the same price under comparable circumstances. This can be read as the implementation of the hypothetical CUP method in the OECD Guidelines. In making such determinations, it is important to consider the functions, assets and risks of the respective parties to the transaction as well as the business reasons for engaging in the transaction. The perspectives and options both available to the transferee and transferee of the intangible should be taken into account, too. In determining a price, it is essential to look at competitive advantages conferred by the intangibles including the relative profitability and, not to forget, the expected future economic benefits from the transaction. Other factors such as location saving, workforce and MNE group synergies should also be considered. According to the OECD Guidelines “[d]epending on the facts and cir-
cumstances of the individual case, the calculation of the discounted cash flows derived from the exploitation of the intangible should be evaluated from the perspective of both parties to the transaction in arriving at an arm’s length price.”18 The result is a paradigm shift leading to the valuation of IP from a standardized, objective transfer pricing perspective, as the OECD guidance no longer prescribes to separate single intangibles and evaluate them just from one subjective angle (for example, from the seller).

Such a subjective valuation requires a detailed analysis of the valuation object (single IP vs. transfer package) and surrounding functions both from the transferor’s and the transferee’s perspective. Under an income-based valuation approach this results in at least two valuations.

2.5. Determinants of the bilateral valuation

Input factors to distinguish the intangible from the perspective of transferor from that of the perspective of the transferee include the following:

- type of intellectual property (IP) in the context of the commercial relations;
- valuation date;
- functional and risk analysis considering legal property and the DEMPE functions;
- realistic alternatives for action compared to the transactions at hand (closing costs in case of non-transfer);
- comparative advantages from the IP;
- economic lifetime;
- future economic benefits;
- risks and discount factors;
- further non-IP comparables (for example, location savings, workforce); and
- consideration of tax shield and step-up.

How a two-sided valuation has to be conducted and how such a valuation should take into account the determinants, is not prescribed by the OECD. The determinants listed above will generally be reflected in the projected cash flows. Very few countries have experience with bilateral valuations for transfer pricing purposes. Therefore, it is necessary for MNEs to observe how different countries will implement this methodology in their domestic legislation.

2.6. How to account for risks within the bilateral valuation methodology

The presence of risks in the context of the transfer or usage of intellectual property is ubiquitous and therefore needs to be taken into account when determining an arm’s length price. Different types of risks among related parties should be considered when evaluating intangibles, for example:19

- risks related to the expected future development of the intangible. The development risk is especially important in transactions involving partially developed intangibles;
- risks related to the infringement of the rights on intangibles. This includes the possibility that competitors introduce products in the future that harm the position of the analysed product on its relevant market;
- risks related to product obsolescence and depreciation of the value of the intangibles. This includes the possibility that competitors introduce products in the future that harm the position of the analysed product on its relevant market;
- other risks, like product liability related to the future use of the intangibles.

Generally, uncertainties and/or risks are reflected in the corresponding discount rate.20

2.7. Results of the two-sided valuation

Principally, the OECD follows an ex-ante perspective at the valuation date. The expected future economic “benefits”21 have to be identified under a complete transparency of information regarding the situation at the transferor and the transferee.

A two-sided valuation can render the minimum demand of the transferor and the maximum willingness to pay of the transferee. Both values will set the limits for a negotiation range.

In the best case, the actual transaction value of the IP lies within the negotiation range. In other cases, it will not be efficient to transfer the IP at all (for example, when the transferor’s maximum willingness to pay is below the minimum demand of the transferee).

The OECD does not clarify any further how the potentially very broad negotiation range should be narrowed down and comes up with the arm’s length amount between the two limits of the negotiation range as a solution. The means of the negotiation range is chosen as the transaction value and price of the IP, at least in most cases from a German perspective.

Lump-sum payments and time equivalent licence fees are both possible. When the IP has to be classified as HTVI, the OECD suggests to use price adjustment mechanisms and a greater use of profit split methodologies.

3. Impact of Risk on Ex-Post Valuation

3.1. General approach

The OECD generally prefers to handle risks from an ex-ante perspective at valuation date. Nevertheless, under certain circumstances, the ex-ante results need to be validated from an ex-post perspective. In order to do so, it is necessary to differentiate between the following categories of risks and their implications to valuations:

- sufficient predictable events and/or risks;
- insufficient predictable events and/or risks; and
- unpredictable events and/or risks.

The risks have to be identified explicitly and considered and included in the valuation of the IP. It is necessary to document how a specific risk weighs up within the valuation. Three different possibilities to account for these risks will be described in sections 3.2.-3.4.

3.2. Accounting for sufficiently predictable risks

Specifically if the IP is linked to certain products or customers and these products or customers tend to have a certain lifecycle, the risks regarding these lifecycles are generally accounted for when modelling the future cash flows. Based on historic data, such risks seem to be sufficiently identifiable and predictable. Deviations of the income streams in the future that can be linked to assumptions made during the valuation process in that regard should then not be accounted for elsewhere.

Risks that are sufficiently predictable will mostly depend on the nature of the relevant IP itself. When analysing the IP, it is therefore highly important to understand the IP and the DEMPE functions that are inherent to it in detail. Without a thorough understanding of the value chain, it will not be possible to have a qualified opinion regarding the sufficiently predictable risks.

The effects of sufficiently predictable risks can be included in the projected cash flow and/or the relevant discount rates.

3.3. Accounting for not sufficiently predictable risks

According to the OECD, in case of not sufficiently predictable risks, a mere ex-ante approach might not lead to an appropriate arm’s length transaction value. Third parties are deemed to handle not sufficiently predictable risks, for example, with price adjustment clauses or contingent payments. The OECD seems to refer to situations where specific low-probability events are principally known, but their effects of occurrence on the underlying IP are not. Therefore, the transferor and transferee should identify the potential events and make the resulting payments contingent on the specific effect of such an event. As example, the OECD proposes specific milestone payments after certain development stages of the IP have been completed at the level of the transferee.

The approach of the OECD is rather circular, since the potential milestone payments will impact the projected cash flows and therefore the results of the ex-ante valuation.

3.4. Accounting for unsystematic and unpredictable events by implementing price adjustment clauses

In case of unsystematic and insufficiently predictable events that have a low probability of occurrence but can change the fundamental assumptions of the valuation, the OECD considers an ex-post validation and potential adjustment of the ex-ante determined transactional value. According to the OECD, third parties would generally renegotiate the transactional value of the IP or prospectively agree to another mechanism as, for example, a price adjustment clause to their mutual benefit.

If a price adjustment mechanism is missing in the relevant agreement, the tax authorities can in certain cases determine the transaction value ex post based on the assumption that third parties would have agreed on a price adjustment mechanism. This will enable hindsight by the tax authorities.

3.5. Special considerations for HTVIs

When the transfer of IP entails crucial uncertainties about the development of the underlying and related income, the IP has to be categorized as “hard to value intangible” (HTVI). For HTVIs likely no comparables will be available at the time of the transfer. An IP is also categorized as an HTVI if it is only partially developed at the valuation date and its economic benefit is expected to occur several years in the future. The possible applications for HTVIs may be new and cannot be estimated due to insufficient practical experience (for example, new technologies).

The OECD handles special HTVIs in chapter D.3. of the OECD Guidelines and proposes to apply price adjustment clauses. These measures should not include transactions with sufficient ex-ante information on potential risks.

Therefore, ex-ante pricing arrangements have to be based on an appropriate weighting of the foreseeable developments of events that may be relevant for the valuation of the relevant HTVI. In order to evaluate the ex-ante pricing arrangements of MNEs, tax authorities will be entitled to use ex-post evidence about financial outcomes in order to analyse the determination of the arm’s length pricing arrangements, including any contingent pricing arrangement that would have been made between unrelated enterprises.

A price adjustment clause is not necessary, if one of the following requirements is met:

- ex-ante valuation and its underlying assumptions can be documented explicitly and differences regarding the value of (i) unforeseeable events or (ii) considered possibilities in the valuation model can be traced back to it;
- the transaction of the HTVI is part of an advanced pricing agreement;
- the difference between the financial projections and the actual transactional value is lower than 20%; or
- a deviation of higher than 20% occurred after a commercialization period of 5 years has passed after the commercialization of the IP.

3.6. Consequences of the consideration of risk on the transactional value

The policy of the OECD to deviate from the strict ex-ante approach leads to a circularity issue. On the one hand, the ex-ante income/risk situation impacts the possibility of renegotiations and price adjustment clauses. On the other hand, the possibility of renegotiations and price adjustment clauses will impact the ex-ante cash flow/risk situation. To handle this circularity issue and to take into account the possible contingent payments in a two-sided net-income-based valuation model will be a complex issue and the OECD has not yet proposed a solution.

Further, if a company includes a price adjustment clause in its intercompany agreement, there is the chance of a double consideration of the risks involved in the IP transfer. If risks are classified as “not sufficiently predictable” and they are not properly considered in the valuation, it is possible that the risks are fully or partially covered in the discount factor. It could also be argued that when all risks are covered within cash flow projections and contingent payments/price adjustment clauses, a risk-free discount rate should be applied at the level of the transferee, as all risks are reflected in the probability of the occurrence of the single events. The applied risk-free discount rate would be part of the contract regarding the transaction and the assumptions leading to the decision should be documented in detail within the relevant transfer pricing documentation report.

The combination of a price adjustment clause without a risk consideration in the ex-ante determined discount rate may lead to a systematic miss-assessment of the ex-ante discount rate, since the risk structure of the IP will change with the price adjustment clause. As a consequence, for example, the price adjustment clause can cause an opposite correction of an initially underestimated transactional value, even though risks were considered appropriately in the valuation. To put it in a nutshell, a double consideration of risks ex ante and ex post can result in a transaction value that does not reflect the arm’s length principle, because if a price adjustment is conducted based on ex-post information, only ex-post information determines the adjusted transactional value.

A price re-negotiation after the realization of risk between unrelated parties is possible according to the OECD guidance, but very unrealistic because it is quite obvious that only one party benefits from a later price adjustment. This precludes a re-negotiation as one party will insist on the agreed contractual basis.

All in all, the authors expect that to take account of risks in the valuation of IP will be a highly debated subject. It will therefore be crucial to highlight the assumptions regarding risks and uncertainties in the arm’s length documentation of the transactional value.

4. Conclusion/Prospect

This article shows that even the identification of the valuation object and the choice of the valuation method contain potential for conflict with and between tax authorities. To harmonize international taxation, a bilateral valuation method approach should meet most international requirements in the future. Consequently, the requirements concerning IP valuations in a fiscal context increase through the OECD BEPS Project. The valuation methods along with the underlying assumptions made for risks and the agreed ex-ante price adjustment clauses have to be documented in detail.

If an event occurs which was not identified as a risk from an ex-ante perspective, tax officials will likely impose an adjustment to the transactional value from an ex-post perspective. Since a two-sided valuation approach is applied, one of the tax offices will always have the incentive to impose such an adjustment based on hindsight.

In terms of evaluation and consideration of single risks, no clear standards for two-sided valuations are given by the OECD and the circularity issues described in section 3.6. are unsolved. The authors also expect that many intangibles in a transfer pricing context are likely to be classified as HTVI, especially as digitization continues and value chains are changing more rapidly than ever before, which will further complicate the matter. HTVIs will establish the price adjustment mechanism as the norm in IP-related transfer pricing.

Without an international valuation standard, the authors expect a lot of discussions with and between tax auditors when handling potential double taxation in the tax audits to come. Therefore, MNEs need to invest even more time and effort ex ante to prepare the cases for the transfer of IP and to outline their taken approaches especially regarding the assumed risks.

Getting a head start in IP valuation will be key for MNEs in order to secure a safe stand regarding their position in the discussions to come.