EXAMINATION OF THE TRANSFER PRICING CHALLENGES OF HARD TO VALUE INTANGIBLES (HTVI)

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Abstract

The Arm's Length Principle (ALP) is the cornerstone of the current transfer pricing regime. The application of the ALP is predicated on using the price charged in transactions between independent entities in an open market to determine or benchmark the appropriate transfer price to be charged in transactions between associated entities within a Multinational Corporation (MNC) Group. At the time when the ALP was adopted, transactions in tangible items were prevalent and there were comparative market prices to determine the appropriate transfer price. The ALP was therefore considered as the best possible means to ensure that profits of associated entities derived from cross-border transactions are allocated in a way that is fair between the MNCs and the different tax jurisdictions in which they are doing business. However, advancements in technology gave rise to new business models that shifted transactions from the traditional tangible items to intangible items. These intangible items are unique items in the sense that they are hard to value due to the absence of comparative market prices to determine the transfer price. This constitutes a practical challenge to the application of the ALP which can creat opportunities for tax avoidance. The objective of this article is to examine the nature of Hard to Value Intangible and its challenges to the application of the ALP. The article will also examine the recommendations proposed by the Organisation for Economic Cooperation and Development to overcome this challenge. The article examined the transfer pricing treatment of intangibles in Nigeria.

Keywords: International Taxation, Transfer Pricing, Intangibles, Arm's Length Principle, Tax Avoidance

1.0 Introduction

Globalisation freed the erstwhile geographical and territorial limitations and boundaries in international trade and business activities. This led to the emergence of Multinational Corporation (MNC) Groups that could extend their business activities and operations to other countries.[1] A MNC Group is usually consisted of a parent-company and other subsidiary companies located in different countries that are under the management and control of the parent company thereby creating a parent-subsidiary relationship within the group. The parent-

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[1] Lazarus A. A. 'Multinational Corporations' in Smelser N. J. and Baltes P. B. (eds.) *International Encyclopaedia of Social and Behavioural Sciences* (New York: Elsevier 2001) 1099

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company and other subsidiary companies of the MNC Groups are also regarded as 'associated entities' bearing in mind that they are under common control and management. The geographical boundaries between different companies within the MNC Groups makes it possible for international transfer of goods and services to occur within the group and necessitate the need to set or determine the price of such transactions.[2] The process of determining the price of transactions between companies within a MNC Group is known as 'transfer pricing' while the negotiated price of such transaction is known as 'transfer price'.

The MNCs, may sometimes, exploit their parent-subsidiary relationship to manipulate the transfer price of the transaction within their group to avoid or evade tax. The manipulation of transfer price to avoid or evade tax is known as abuse of transfer pricing which is generally regarded as a form of tax avoidance and evasion. The susceptibility of transfer pricing to abuse and manipulation by MNCs to avoid or evade tax spurred various governments around the world to put in place machineries to regulate transfer pricing to prevent its abuse and manipulation by MNCs.

To this end, the Organisation for Economic Cooperation and Development (OECD) in its 1963 Model Tax Convention recommended the Arm's Length Principle (ALP) as the international standard for assessing the appropriate transfer price to be charged in transaction between associated entities.[3] Following in the step of the OECD, the United Nations (UN) in 1980 also adopted the ALP as the standard for assessing transfer pricing.[4] With its adoption by both the OECD and the UN member countries, the ALP became the basis of transfer pricing rules in various countries to prevent the abuse of transfer pricing.[5] According to Shaheen, the ALP has been adopted by more than 100 developed, emerging and developing countries as the basis of their transfer pricing rules.[6] This position is supported by a survey conducted by PricewaterhouseCoopers (PWC) in 2016 in respect of transfer pricing rules of 97 countries including Nigeria.[7] The finding of the study revealed that out of the 97 countries surveyed, only Brazil was not using the ALP as the basis of its transfer pricing rule.[8]

The application of the ALP is predicated on treating the associated entities within a MNC Group as separate, distinct or independent entities.[9] This implies that where a MNC operates in another jurisdiction/country through a subsidiary or a branch, such subsidiary or branch will be treated as a separate entity from other subsidiaries of the MNC.[10] The ALP, therefore, allows tax authorities to treat the various subsidiary companies of a MNC Group as independent entities with the consequent implication that the prices and conditions of any transaction

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[2] Ibid

[3] Ruiter D. M., 'Overview of the OECD work on transfer pricing'(2015) <https://www.taxjustice.net/.../Marlies-de-Ruiter> accessed on 15 May 2021

[4] Ibid

[5] OECD, 'Transfer Pricing Legislation – A Suggested Approach' <http://www.oecd.org/.../transfer-pricinglegislation-a-suggested-approach.html/> accessed on 4 May 2021

[6] Shaheen S., 'Why OECD's Arm's Length Principle (ALP) is under threat' <http://www.tpweek.com/Article/3048664/Why-OECDs-ALP-is-underthreat.html> accessed on 12 May 2021

[7] PricewaterhouseCoopers (PWC), International Transfer Pricing 2015/2016' http://www.pwc.com/internationaltp 775 accessed on 12 May 2021

[9] OECD, 'Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations' (2010) <http://www.oecd.org/ctp/transfer-pricing/45763692.pdf> accessed on 15 April 2021

[10] Kobetsky M., *International Taxation of Permanent Establishments: Principles and Policy* (Cambridge University Press, Cambridge 2011) 70

between such associated entities must not in any way differ from the prices and conditions that would have been obtainable in a similar comparable transaction between independent entities.[11]

To achieve this, a MNC is required to identify a market-based price of transactions between independent entities to determine the appropriate transfer price that could be charged in respect of transaction between associated entities. The open market place comprising of prices charged by independent entities in similar transactions is therefore the measure to benchmark or verify the appropriate transfer price to be charged in transactions between associated entities and it is what determines whether or not transfer price has been manipulated or abused by a MNC to avoid or evade tax.[12] This benchmarking system is commonly referred to as a '**comparability analysis**' and it is regarded as the heart of the application of the ALP and it is the determinant factor as to whether or not the transfer price has been abused or manipulated.[13]

At the point of the adoption of the ALP, transactions in tangible items was prevalent. This made the application of the ALP a simple one as the market price of tangible items can easily be obtained in comparable transactions between independent entities. The availability of comparative market price of tangible items also made the application of the ALP to look straight forward in theory and practice.[14] The ALP was therefore regarded as the most appropriate means to determine or benchmark the appropriate transfer price to be charged in transactions between associated entities.[15]

However, advancements in technology gave rise to new business models that shifted trading from the traditional tangible items to intangible items. These intangible items are unique items that are usually hard to value due to the fact that, unlike the tangible items, there are usually little or no comparative prices in the open market to determine or benchmark the appropriate transfer price to be charged in transactions involving transfer of intangible items between associated entities.

This constitute a serious challenge to the practical application of the ALP that is premised on using the price charged in a comparable transaction between independent entities to benchmark or determine the appropriate transfer price to be charged in a transaction between associated entities. This, therefore, created opportunities for MNCs to set the price of transactions involving intangibles in such a way to avoid or evade tax bearing in mind there is no comparable open market price that can be used to benchmark or determine the appropriate transfer price to be charged in this regard.

This article therefore examined the nature of Hard to Value Intangibles (HTVI) and the challenges posed to the application of the ALP. The article also examined the recommendations of the OECD to over the challenges in this regard as well as the present transfer pricing

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[11] European Union, 'Arbitration Convention on the elimination of Double Taxation in connection with the adjustment of profits of associated enterprises' (1990) <http://www.wu.ac.at/fileadmin/wu/d/i/taxlaw/institute/WU_Global_Tax_Policy_Center/Arbitration/arb_2/EU_Arbitration_Convention-_Draft.pdf> accessed on 15 April 2021

[12] United Nations, 'Practical Manual on Transfer Pricing for Developing Countries' (2013) <http://www.un.org/esa/ffd/documents/UN_Mannual_TranferPricing.pdf> accessed on 15 April 2021

[13] OECD, 'OECD/G20 Base Erosion and Profit Shifting Project: Aligning Transfer Pricing Outcomes with Value Creation' <http://dx.doi.org/10.1787/9789264241244-en> accessed on 15 April 2021

[14] OECD, 'Review of Comparability and of Profit methods: Revision of Chapters I-III of the Transfer Pricing Guidelines' Centre for Tax Policy and Administration <http://www.oecd.org/ctp/transfer-pricing/45763692.pdf> 7 accessed on 15 April 2021

[15] Ibid

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treatment of intangibles in Nigeria. The article employed a doctrinal legal research methodology. Accordingly, the article relied on materials such as journal articles, textbooks, dissertations, theses, OECD/G20 BEPS Final Report, OECD publications, Income Tax (Transfer Pricing) Regulations 2018 and so on. These materials were subjected to content legal analysis.

3.0 Meaning of Intangibles

It is important to understand the meaning of intangibles as this will provide the basis for proper understanding of 'Hard to Value Intangibles' in transfer pricing context. The term 'intangible' is defined as a 'non-physical and non-monetary assets of a firm'.[16] It is also defined as a 'nonphysical sources of value (claims to future benefits) generated by innovation (discovery), unique organisational designs, or human resource practices.[17]

Generally, intangibles are usually classified into three categories namely: intellectual capital, intangible assets and intellectual property.[18] The first category, that is, 'intellectual capital' consists of intangibles such as company's reputation and social capital, innovation, human capital, tacit knowledge or knowledge/information capital, organisational synergies, and non-contractual relations to customers or suppliers.[19] The second category, that is, 'intangible assets' comprises of corporate culture, know-how, operational guidelines, best practices, internal process set-ups or process-embedded technology, training and personnel development measures, and a successful management team.[20] The third category, that is 'Intellectual property', includes intangibles such as 'patents, trademarks, different types of rights (e.g. copyrights and/or licences) covering the utilization of patents, of literary works, databases, exploration of natural resources or trade secrets or designs'.[21]

It is important to note that while there are usually no transactions between independent parties in respect of first and second categories of intangibles (intellectual capital and intangible assets), transactions can be found between independent entities in respect of the third category (Intellectual property) of intangible that can enjoy legal protection.[22] In addition, the third category of intangibles have a higher level of autonomy (separability) from their holders, that is, such intangibles may be transferred from one party to another without losing (much of) their value.[23]

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[16] Brauner Y., 'Value in the Eye of the Beholder: The Valuation of Intangibles for Transfer Pricing Purposes' (2008) 28 Virginia Tax Review 87

[17] Ibid 89

[18] Lagarden M, 'Intangibles in a Transfer Pricing Context: Where Does the Road Lead?' (2014) 5 International Transfer Pricing Journal 333

[19] Ibid

[20] Ibid 334

[21] Ibid 334

[22] Fedusiv O., 'Transfer Pricing Treatment of Transactions with Hard-to-Value Intangibles: Is BEPS Action 8 Based on the Arm's Length Principle?' (LLM Thesis, Lund University 2016) 11

[23] Ibid

3.0 Intangibles Within the Context of Transfer Pricing

The classification of intangibles with the context of transfer pricing is quite different from the above general classification of intangibles. Within the transfer pricing context, the OECD classified intangibles into two broad categories namely: marketing and trade intangibles.[24]

Marketing intangibles includes trademarks and trade names that aid in the commercial exploitation of a product or service, customer lists, distribution channels and unique names, symbols or pictures that have an important promotional value for product concerned.[25] Trade intangibles, on the other hand, include patents, know-how, designs, and models that are used for the production of a good or the provision of a service as well as intangible rights that are themselves business assets transferred to customers or used in the operation of business (e.g. computer software).[26]

It is quite obvious obvious that the OECD's classification relies mainly on the third general category of intangibles, that is, 'intellectual property'. Thus, classification of intangibles within the transfer pricing context does not take into consideration the first and second categories of the general classification of intangibles, that is, 'intellectual capital' and 'intangible assets'.[27]

4.0 Nature of Hard to Value Intangibles (HTVI)

Generally, transactions between associated entities in respect of intangible items are divided into three namely: a sale and purchase, a license and a joint development.[28] The 'sale and purchase' and 'license' transactions involves a situation a situation whereby one associated entity creates an intangible and transfers (sells or licenses) it to another associated entity while the 'joint development' transaction involves a situation whereby two or more associated entities contribute to the creation of an intangible and mutually benefit from it thereafter.[29]

As stated earlier, the ALP is the international standard for assessing the transfer price to be charged by associated entities in any transaction between them. This means that in any transaction involving transfer of intangibles between associated entities, it is the price charged between independent entities in a similar comparable transaction that will be used to benchmark the transfer price to be charged between the associated entities.

To do this, the associated entities will have to obtain the price of a comparable transaction between independent entities in the open market to set the price of the transfer of the intangibles. Where the associated entities are able to obtain such information in the open market they can easily set the transfer price of the transaction but where a comparative price is not readily available in the open market, setting the transfer price of such intangible becomes difficult as it is one that is hard to value.

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[24] OECD, 'Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations' (2010) <http://www.oecd.org/ctp/transfer-pricing/45763692.pdf> accessed on 15 April 2021

[25] Ibid

[26] Ibid

[27] Fedusiv O., 'Transfer Pricing Treatment of Transactions with Hard-to-Value Intangibles: Is BEPS Action 8 Based on the Arm's Length Principle?' (LLM Thesis, Lund University 2016) 11

[28] Boos M., *International Transfer Pricing: The Valuation of Intangible Assets* (Kluwer Law International 2003) 8, Lagarden M, 'Intangibles in a Transfer Pricing Context: Where Does the Road Lead?', (2014) 5 International Transfer Pricing Journal 333

[29] Ibid

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Accordingly, Hard to Value Intangibles (HTVI) are defined as '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 cash flows or income expected to be derived from the transferred intangible, or the assumptions used in valuing the intangible are highly uncertain'.[30] The term HTVI covers intangibles or rights in intangibles for which there is no reliable open market price which makes it difficult to value the intangible at the time of the transfer.[31] This is a broad definition that is likely to include almost if not all intangibles.

From the above definition of HTVI, it can rightly be posited that the features and characteristics of HTVI may include:

i. The intangible is only partially developed at the time of the transfer;
ii. It is not expected to be exploited commercially until several years following the transaction;
iii. It is integral to the development of other hard-to-value-intangibles;
iv. It is expected to be exploited in a novel manner, making reliable projections from past developments unavailable;
v. It is transferred to an associated entity for a lump sum payment;
vi. It is used, in connection with or developed under a cost contribution arrangement or similar arrangements;
vii. There are not comparable to intangibles used by or available to parties to potentially comparable transactions;
viii. The intangible is expected to yield greater future economic benefits than would be expected in the absence of the intangible.[32]

5.0 Transfer Pricing Challenges of Hard to Value Intangibles (HTVI)

The application of the ALP, as stated earlier, is predicated on using the price charged by independent entities in a comparable transaction to determine or benchmark the appropriate transfer price to be charged in a transaction between associated entities. When the ALP was developed and adopted in 1963 by the OECD in its Model Tax Convention, it was aimed at transaction involving tangible items which was prevalent at that time.[33] At that time, allocation of profits and income on geographical basis prevailed thereby allowing tax authorities to treat subsidiaries of MNCs in other jurisdictions as autonomous and separate entities in respect of transactions between them.[34]

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[30] OECD, 'Guidance for Tax Administrations on the Application of the Approach to Hard-to-Value Intangibles - BEPS Actions 8-10, OECD/G20 Base Erosion and Profit Shifting Project' <http://www.oecd.org/tax/beps/guidance-for-tax-administrations-on-the-application-of-the-approach-tohard-to-value-intangibles-BEPS-action-8.pdf> accessed on 29 April 2021

[31] Ibid

[32] OECD, 'Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports, OECD/G20 Base Erosion and Profit Shifting Project' <http://dx.doi.org/10.1787/9789264241244-en> accessed on 20 April 2021

[33] Schön W. and Konrad K.A., *Fundamentals of International Transfer Pricing in Law and Economics* (MPI Studies in Tax Law and Public Finance, Springer-Verlag 2012) 137

[34] Ernst & Young, 'Global Transfer Pricing Survey: Addressing the Challenges of Globalization' (2010) <http://www.ey.com/gl/en/services/tax/international-tax/2010-global-transfer-pricing-survey> accessed on 12 April 2021

However, nowadays, the increasing importance of intangibles has exacerbated and constitutes a sort of achilles heel to the application of the ALP as the intangibles usually do not have ties to a specific location and are often unique and difficult to value.[35] This constitutes a serious practical challenge that has, in no small measure, undermined the effectiveness of the ALP to determine the appropriate transfer price of transactions involving intangibles. It has therefore been argued that the ALP is unlikely to have long-term viability as it is not capable of resolving transfer pricing issues associated with transfer of intangibles items.[36]

Some of the transfer pricing challenges posed by the HTVI to the application of the ALP are considered below:

5.1 Lack of Comparable

The application of the ALP is premised on setting the transfer price of transaction between associated entities in such a way to reflect the price that would have been charged were the transaction between independent entities. An important exercise in the application of the ALP involves finding the prices of comparable transactions between independent entities to determine or benchmark the appropriate transfer price to be charged. This is known as 'comparability analyses'.

However, because of unique nature of HTVI, they are usually hard to value because they do not have comparative price in the open market and hence they are considered non-tradable.[37] The lack of comparative price in the open market is therefore likely to complicate 'comparability analyses' which is important to the application of the ALP.[38] This is due to the fact that comparables for HTVI rarely exist[39] as MNCs are unwilling to dispose of 'certain unique intangibles with high profit potentials'.[40]

The absence of comparables in this regard therefore constitute a significant and a major challenge to the application of the ALP. The consequent implication of this is that tax authorities and taxpayers may deviate from the ALP which can produce significant value differences.[41]

5.2. Unreliability of Data

Even in situation where the market price for certain intangibles exists, the reliability of the available data may be a great challenge. Comparability analysis requires plenty of information and data about transactions involving intangibles between independent entities. Little deviations may result in significant value differences that may undermine the whole exercise.

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[35] Schön W. and Konrad K.A., *Fundamentals of International Transfer Pricing in Law and Economics* (MPI Studies in Tax Law and Public Finance, Springer-Verlag 2012) 137

[36] Ibid 283

[37] Brauner Y., 'Value in the Eye of the Beholder: The Valuation of Intangibles for Transfer Pricing Purposes' (2008) 28 Virginia Tax Review 96

[38] Fedusiv O., 'Transfer Pricing Treatment of Transactions with Hard-to-Value Intangibles: Is BEPS Action 8 Based on the Arm's Length Principle?' (LLM Thesis, Lund University 2016) 13

[39] Boos M., 'International Transfer Pricing: The Valuation of Intangible Assets' (Kluwer Law International 2003) 12

[40] Ibid 9

[41] Fedusiv O., 'Transfer Pricing Treatment of Transactions with Hard-to-Value Intangibles: Is BEPS Action 8 Based on the Arm's Length Principle?' (LLM Thesis, Lund University 2016) 14

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Hence, 'the availability and quality of the information and data' are therefore very crucial Independent entities often transfer intangibles as part of the disposal of a whole busines Under such circumstances reliability of data about one of the transaction's elements (i intangible) may be questionable without paying attention to the overall transaction.[44]

5.3. Inseparability of Intangibles

It is common for MNCs to combine intangibles with tangible or financial assets.[45] In su situations, proper delineating of the value of an intangible in the total value of a product m be quite a problematic task. This problem consequently affects the accuracy of a comparabili exercise (if comparables are available at all). Delineating value of a particular brand, which definition is unique, in the total value of a product could be a challenging exercise. As a resu the comparability analysis may be impracticable or, if taken, be highly unreliable because its speculative adjustments.[46]

Furthermore, if an intangible is inseparable from the rest of enterprise's assets, it is likely to attributed to the category of 'intellectual capital' or 'intangible assets', rather than 'intellectu property'. This means that the market for such intangible is unlikely to exist and, as a resul the reliability of the transfer pricing analysis is again brought into question.[47]

5.4. Difficulty of Valuation

One of the unique feature and nature of HTVI is that its value usually lies in the future.[48] Thi means that the valuation of intangibles is based on estimations that 'might be subject to a high degree of uncertainty'.[49] The implication of this is that there is no clear interplay between the cost of the intangible and the value that may be derived from it. This limits the valuation methods that may be applied to transactions with intangibles as opposed to tangible assets. [50]

The above transfer pricing challenges posed by HTVI brings into question viability of the use of the ALP to intangibles. The lack of comparables puts into the limelight the very fundamental question of whether the ALP is still suitable to resolve all transfer pricing tasks and whether it is necessary to replace the ALP in this regard.

6.0. Response to The Transfer Pricing Challenges of HTVI

To overcome the transfer pricing challenges of HTVI, the OECD initially considered the use of special measures that may have operated outside the ALP including the characterisation of

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[42] Brauner Y., 'Value in the Eye of the Beholder: The Valuation of Intangibles for Transfer Pricing Purposes' (2008) 28 Virginia Tax Review 106

[43] Ibid 107

[44] Fedusiv O., 'Transfer Pricing Treatment of Transactions with Hard-to-Value Intangibles: Is BEPS Action 8 Based on the Arm's Length Principle?' (LLM Thesis, Lund University 2016) 14

[45] Ibid

[46] Ibid 15

[47] Ibid

[48] OECD, 'Guidance for Tax Administrations on the Application of the Approach to Hard-to-Value Intangibles - BEPS Actions 8-10, OECD/G20 Base Erosion and Profit Shifting Project' <http://www.oecd.org/tax/beps/guidance-for-tax-administrations-on-the-application-of-the-approach-tohard-to-value-intangibles-BEPS-action-8.pdf> accessed on 29 October 2018

[49] Boos M., 'International Transfer Pricing: The Valuation of Intangible Assets' (Kluwer Law International 2003) 36

[50] Ibid

intangible transactions and the application of other anti-abuse provision.[51] However, instead of jettisoning the ALP because of the challenges posed by HTVI in this respect, the OECD Secretariat recommended that the ALP should rather be reformed to overcome its challenges.[52]

The OECD contends in this regard that since the ALP is widely recognised as the international standard for assessing transfer pricing, a sudden move away from the ALP will lead to a disproportionate allocation of income and profits in different tax jurisdictions and will also increase the risk of double taxation.[53] It was, therefore, the recommendation of the OECD that experiences garnered from the application of the ALP should be drawn upon to refine and improve its application to HTVI by providing clearer guidance to taxpayers and tax authorities.[54]

The reforms recommended by the OECD in this regard formed part of the 15-Action Plan developed by the OECD in conjunction with the G20 to address the issue of Profit Shifting under a general package known as Base Erosion and Profit Shifting (BEPS) Project.[55] Base Erosion and Profit Shifting (BEPS) is a term generally used to refer to all forms of schemes/strategies employed by MNCs to artificially shift profits and income from high tax jurisdictions to low or no-tax jurisdictions/countries.[56]
The 15-Action Plan otherwise known as the BEPS Project was endorsed by the G20 leaders in November 2015.
The 15-Action Plan equips the governments with the domestic and international instruments needed to prevent profit shifting from high jurisdictions to low or no tax jurisdictions.[57] The 15-Action Plan are:

1. Address the tax challenges of the digital economy;
2. Neutralise the effects of hybrid mismatch arrangements;
3. Strengthen CFC rules;
4. Limit base erosion via interest deductions and other financial payments;
5. Counter harmful tax practices more effectively, taking into account transparency and substance;
6. Prevent treaty abuse;
7. Prevent the artificial avoidance of PE status;
8. Intangibles;
9. Risks and capital;
10. Other high-risk transactions;
11. Establish methodologies to collect and analyse data on BEPS and the actions to address it;
12. Require taxpayers to disclose their aggressive tax planning arrangements;
13. Re-examine transfer pricing documentation;

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[51] Sidher Sajeev and Schmidtke R., 'A practical guide to BEPS changes: Hard-to-value-intangibles' <http://www.deloitte.com> accessed on 29 October 2018
[52] OECD, 'Action Plan on Base Erosion and Profit Shifting' <http://dx.doi.org/10.1787/9789264202719-en> 14 accessed on 15 May 2021
[53] Ibid 36
[54] Ibid
[55] OECD, 'Base Erosion and Profit Shifting (BEPS)' 'https://www.oecd.org/g20/topics/taxation/' accessed on 15 May 2021
[56] Ibid
[57] Ibid

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14. Make dispute resolution mechanisms more effective; and
15. Develop a multilateral instrument.

This article will only consider Action 8 of the BEPS Project which is geared towards overcoming the challenges posed by the HTVI.

6.1. Application of BEPS Action Plan 8 To Hard to Value Intangibles

The primary goal of the BEPS Action Plan 8 is to prevent base erosion and profit shifting that can occur due to moving of intangibles among associated entities of the MNCs.[58] To this end, the BEPS Final Report provides a set of recommendations of how to tackle the transfer pricing challenges of HTVI.

The BEPS Final Report on Action Plan 8 recommended for the adoption of rules to measure the value of transfers of HTVI and rules to ensure that income and profits from transfer of intangibles are allocated in accordance with value creation.[59] The purpose of this is to ensure that MNCs do not take advantage of unique features of HTVI such as patents, brand name, license, franchise, trademark to shift income and profits from high tax jurisdictions to low or no tax jurisdictions.

The BEPS Final Report on Action Plan 8 also recommended a revision of the meaning of Intangible Property. In this regard, The BEPS Final Report on Action Plan 8 admitted that the present definition of intangibles provides a difficulty in determining the meaning of 'intangibles' for transfer pricing purposes due to the fact that a narrow definition could exclude certain items from the scope of intangibles while a broad definition of intangibles could encompass certain elements which do not belong to intangibles.[60] To address the challenge of definition in this regard, BEPS Final Report Action Plan 8 defined the term 'intangibles' in the following manner:

> Something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances.[61]

This new definition departed from the mechanical definitions that are common in accounting or legal field. Instead, the new definition point out that circumstances of each case should be considered to ascertain whether a transaction between associated parties involve intangibles and, if yes, whether the use or the transfer of such intangibles would be compensated in a transaction between independent parties.

In this respect, BEPS Final Report on Action Plan 8 furnishes tax authorities and taxpayers with a certain level of flexibility as it recognises the fact that the concept of 'intangibles' for

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[58] OECD, 'Action Plan on Base Erosion and Profit Shifting' (2013) <https://www.oecd.org/ctp/BEPSActionPlan.pdf> accessed 2 May 2021

[59] Ibid

[60] OECD, 'Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports, OECD/G20 Base Erosion and Profit Shifting Project' <http://dx.doi.org/10.1787/9789264241244-en> accessed on 20 August 2018

[61] Ibid Para 6.6

transfer pricing purposes may differ from its use for general tax purpose[62] and that the availability of legal, contractual or other forms of protection in respect of particular item is not a prerequisite for it to be treated as the intangible.[63] In addition, the definition of intangibles provided by the BEPS Final Report on Action Plan 8 is to the effect that an item may be characterised as an intangible even if it could not be transferred separately from other assets.[64]

Furthermore, the BEPS Final Report on Action Plan 8 elaborate on the concept of 'unique and valuable' intangibles which have not been before. It defined unique and valuable' as follows:

> Unique and valuable" intangibles are those intangibles (i) that are not comparable to intangibles used by or available to parties to potentially comparable transactions, and (ii) whose use in business operations (e.g. manufacturing, provision of services, marketing, sales or administration) is expected to yield greater future economic benefits than would be expected in the absence of the intangible.[65]

This definition exposes two major transfer pricing challenges of HTVI to the application of the ALP, that is, the lack of comparables and the difficulties with predicting ultimate success of the intangible at the time associated enterprises transact which had earlier been examined in this article. To overcome this challenge, BEPS Final Report on Action Plan 8 introduces special rules to equip tax administrations with an additional tool to examine transfer prices that associated entities set in relation to the transfer or the use of HTVI.

The application of this rule is premised on verifying transfer prices on the actual outcome of the transaction, rather than projections made by parties at the time the transaction was made.[66] The rationale behind this special measure is that tax authorities suffer from information asymmetry when assessing transfer prices in HTVI transactions as they may not have 'specialised knowledge, expertise and insight into the business environment in which the intangible is developed or exploited.[67] In order to ensure that tax authorities are not disadvantaged because of an information asymmetry in this respect, the BEPS Final Report on Action Plan 8 allow tax authorities to examine 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 in determining the transfer price for the transfer of such intangibles or rights in intangibles.'[68]

This special rule therefore allows tax authorities to use actual financial outcomes to evaluate transfers relating to HTVI. In this regard, it will be presumed that the transfer price of a HVTI is not at arm's length if there are material differences between the forecasts used to price the

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[62] Ibid Para 6.7
[63] Ibid Para 6.8
[64] Ibid Para 6.8
[65] Ibid Para 6.17
[66] Fedusiv O., 'Transfer Pricing Treatment of Transactions with Hard-to-Value Intangibles: Is BEPS Action 8 Based on the Arm's Length Principle?' (LLM Thesis, Lund University 2016) 18
[67] OECD, 'Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports, OECD/G20 Base Erosion and Profit Shifting Project' <http://dx.doi.org/10.1787/9789264241244-en> accessed on 20 August 2018
[68] Ibid Para 6.188

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transaction and the actual financial outcome of the intangible transfer. This is what is referred to as *ex post* assessment, that is, verification of transfer prices on the actual outcome of the transaction, rather than projections made by parties at the time the transaction was made.

There are however four exemptions under which *ex post* assessment does not apply to HTVI transactions. The first is where the taxpayer can satisfactorily show what was foreseeable at the time of the transaction and how this forecast is reflected in the pricing assumptions and that the difference between *ex ante* projections (that is, financial projection at the time of the transfer) and *ex post* results is due to unforeseeable developments or events.[69] The second exemption is where the transfer of HTVI is covered by an advance pricing arrangement ('APA'); while the third exemption is where the significant differences between financial projection and the actual outcomes do not cause the projected compensation for the HTVI to deviate by more than 20 per cent. The fourth exemption is where the HTVI has generated unrelated entity revenues for the transferee for a five-year commercialisation period and any difference between the financial projection and the actual outcome is less than or equal to 20 per cent of the forecast for that period.[70]

The *ex post* approach in BEPS Final Report on Action Plan 8 may be summarised in the following algorithm: 'When tax administrations audit transactions involving HTVI they may rely on *ex post* results (that is, the actual financial outcomes to evaluate transfers relating to HTVI) because they usually suffer from information asymmetry. However, taxpayers may rebut reliance on *ex post* results provided they can prove that the HTVI transfer falls under any of the recognised exemptions.[71]

7.0 Transfer Pricing Treatment of Intangibles in Nigeria

The transfer pricing treatment of intangibles in Nigeria is provided by the provision of Paragraph 7 of the Income Tax (Transfer Pricing) Regulations 2018 (Regulation) which was released by the FIRS in September 2018.[72] This was a revision to the Income Tax (Transfer Pricing) Regulations 2012 under which there was no defined transfer pricing rules on how intangibles are to be treated in Nigeria. The FIRS therefore deserve commendation for taking this bold and significant step to align the country's transfer pricing regulation with international best practices as recommended by the OECD/G20 BEPS Project.

The Regulation stipulated that determining the arm's length price and conditions for transactions between associated entities involving the exploitation of an intangible is expected to take into account the contractual arrangements and the following factors with regard to the development, enhancement, maintenance, protection and exploitation of the intangible asset, the -

i. functions performed by the person;
ii. management and control of those functions;
iii. contribution by the person of assets, including financial assets,

[69] Ibid Para 6.194
[70] Ibid Para 6.194
[71] Fedusiv O., 'Transfer Pricing Treatment of Transactions with Hard-to-Value Intangibles: Is BEPS Action 8 Based on the Arm's Length Principle?' (LLM Thesis, Lund University 2016) 20
[72] Income Tax (Transfer Pricing) Regulations Government Notice No. 60 Vol. 105 B113-140 2018

iv. management and control regarding the contribution of assets, including financial assets;
v. risks assumed by that person; and
vi. management and control of those risks.[73]

Further to this, determining the arm's length conditions for transactions involving licenses, sales or other transfers of intangible property between associated entities is also expected to take into account both the perspective of the transferor of the property and the perspective of the transferee, including in particular the pricing at which a comparable independent person would be willing to transfer the property and the value and usefulness of the intangible property to the transferee in its business.[74] In doing this, the Regulation provided that consideration shall be given to any special factors relevant to the comparability of the controlled and uncontrolled transactions, including -

i. the expected benefits from the intangible property;
ii. the commercial alternatives otherwise available to the acquirer or licensee derived from the intangible property;
iii. any geographic limitations on the exercise of rights to the intangible property;
iv. the exclusive or non-exclusive character of the rights transferred; and
v. whether the transferee has the right to participate in further developments of the intangible property by the transferor.[75]

The Regulation also stipulated that in any transaction between associated entities involving the transfer of rights in an intangible other than the alienation of an intangible, the allowable deduction for tax purposes shall not exceed 5% of the earnings before interest, tax, depreciation, amortisation and that consideration, derived from the commercial activity conducted by the person in which the rights transferred are exploited.[76]

From the foregoing, it can be rightly posited that the provision of Paragraph 7 of the Income Tax (Transfer Pricing) Regulations 2018 is merely trying to align the treatment of intangibles in Nigeria with recommendations of the BEPS Final Report on Action Plan 8 of the OECD/G20 BEPS Project. This will go a long way to align transfer pricing outcomes of HTVI transaction with Value Creation as recommended by Action 8 of the OECD/G20 BEPS Project.

Another important provision is the limitation of allowable deduction to 5%. This will prevent arbitrary deduction that is merely meant to avoid or evade tax. It is left to be seen how effective the Paragraph 7 of the Income Tax (Transfer Pricing) Regulations 2018 will be bearing in mind that the provision is a new one in the country with regard to the transfer pricing treatment of intangibles.

8.0 Conclusion and Recommendation

The article examined the transfer pricing challenges of Hard to Value Intangibles (HTVI). According to the article, HTVI covers intangibles or rights in intangibles for which there is no reliable open market price which makes it difficult to value the intangible at the time of the

[73] Paragraph 7(1a-f) Income Tax (Transfer Pricing) Regulations 2018
[74] Paragraph 7(3) Income Tax (Transfer Pricing) Regulations 2018
[75] Paragraph 7(4a-e) Income Tax (Transfer Pricing) Regulations 2018
[76] Paragraph 7(5) Income Tax (Transfer Pricing) Regulations 2018

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transfer. This difficulty to determine the value of these intangibles present transfer pricing challenges which can lead to tax avoidance or evasion.

The finding of the article revealed that the ALP is standard for determining the appropriate transfer price to be charged in a transaction between associated entities. However, HTVI are unique intangibles items for which there are usually no comparative/comparable prices in the open market and are therefore hard to value. This raises some transfer pricing challenges in the application of the ALP which is premised on using prices charge in the open market in transactions between independent entities to benchmark the appropriate transfer price to be charged in transactions between associated entities.

The finding of the article further revealed that to overcome the transfer pricing challenges of the HTVI, the OECD introduced Action Plan 8 into the 15-Action Plan Base Erosion and Profit Shifting (BEPS). Action Plan 8 introduces special rules to equip tax administrations with additional tool to examine transfer prices associated entities set in relation to the transfer or the use of HTVI.

The article also found that Nigeria, in line with BEPS Final Report on Action Plan 8, introduced the treatment of transfer pricing of intangibles in the country in the Income Tax (Transfer Pricing) Regulations 2018. It is recommended that Nigeria should continue to follow up with international developments on the transfer pricing treatment of HTVI as this will go long a way to assist the country to prevent tax avoidance and evasion in this regard.