

# Transfer pricing and IFRS

Implications of IFRS on cost sharing arrangements\*



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Cost sharing arrangements (CSAs), one of the most complex areas associated with international transfer pricing, serve as a popular financial and tax planning tool for many organizations. Financial accounting is often at the heart of these arrangements. In particular, US GAAP has historically been the financial accounting standard most often relied upon for measuring many of the elements within a CSA. As US-based multi-national organizations continue to evaluate their potential move from US GAAP to International Financial Reporting Standards (IFRS), through either continued convergence or ultimate conversion, they will need to consider how changing accounting policies may potentially impact their existing and future CSAs. To help organizations understand how IFRS may impact CSAs, PricewaterhouseCoopers has prepared this Transfer Pricing-IFRS article. Specifically, this article analyzes how IFRS may impact the following key elements of CSAs:

- Reasonably anticipated benefits (RABs)
- The commensurate-with-income standard
- Intangible development costs (IDCs)

## Cost sharing agreements— an overview

A CSA is an arrangement in which two or more parties agree to share the costs to develop intangible property (IP) in exchange for an ownership interest in the newly generated IP. IP may include legally protected assets, such as patents and trademarks, and non-legally protected assets, such as know-how and confidential trade secrets.

The sharing of costs within these arrangements are typically based on RABs (i.e., projections of economic benefits that a party anticipates deriving from the newly developed IP). There are various manners in which RABs are measured. Two common methods include:

- Measuring revenue
- Utilizing a profitability measurement (e.g., operating profit)

If revenue or a profitability measurement is selected, those methods typically rely on financial accounting to determine the amounts. As noted above, for many US multinational corporations (US MNCs), the financial accounting standard relied upon, historically, has been US GAAP. As companies continue to assess the ongoing convergence between IFRS and US GAAP, as well as the potential ultimate adoption of IFRS in the US, they will need to consider how any changes in accounting policies, most notably those related to revenue and expense recognition, may impact how costs are shared in a CSA and, therefore, how ownership interests are allocated among the CSA participants.

## Revenue and expense recognition— US GAAP vs. IFRS

Differences exist between US GAAP and IFRS with respect to both revenue and expense recognition. In regards to revenue recognition, the guidance in US GAAP is extensive and highly detailed. The guidance for revenue recognition under IFRS consists of more broad principles. As a result, differences often arise between the two standards in several areas, including multiple element arrangements, sales of services, and software revenue recognition.<sup>1</sup>

With respect to expense recognition, there are also several areas of difference between US GAAP and IFRS. Two common examples include expenses associated with internally generated intangible assets and share-based compensation. Please see the PwC IFRS publication, *IFRS and US GAAP, similarities and differences*, for more detailed information on the similarities and differences between IFRS and US GAAP with respect to revenue and expense recognition, as well as other significant areas of pretax accounting.

A simple illustration of the impact that a change in revenue recognition, for example, may have on CSAs is as follows: Assume two parties entered into a CSA to develop a new pharmaceutical product. The cost sharing and ownership interest in the newly developed pharmaceutical product was based on the revenue related to the CSA under US GAAP. Based on this agreement, Party 1 projected its revenue to be \$50. Party 2 also anticipated its revenue to be \$50, thus Party 1 and Party 2 shared the costs associated with this CSA equally. Upon the adoption of IFRS, Party 1's projected revenue changed to \$60 and Party 2's projected revenue changed to \$40. As a result, the RABs from the CSA for Party 1 and Party 2 would be 60% and 40%, respectively, thereby potentially causing the timing associated with and/or the amount of cost sharing to change among the two parties.

### Commensurate with income

Very often in CSAs, one party in the arrangement contributes pre-existing IP (i.e., IP in existence at the establishment of the CSA). In turn, it must be compensated for this contribution through a platform contribution transaction, commonly known as a buy-in payment. Under the US tax law, in cases where pre-existing IP is contributed to a CSA, the commensurate-with-income standard applies.

The commensurate-with-income standard requires related parties to price IP consistent with the expectation that the income associated with the transfer is commensurate with the relative risks and economic activity the parties undertake. Further, under the commensurate-with-income standard, if any IP is transferred or licensed, the income with respect to the transfer or license should be commensurate with the income attributable to the IP. An adjustment may be required if actual financial results differ materially from the expected financial results at the time the transfer was made.

For example, assume Party A and Party B enter into a CSA. Party A, a US corporation, possesses a portfolio of IP that it wishes to license to Party B, the related party located in another jurisdiction. At the time the transaction was consummated, the parties agreed to a royalty rate of 10% based on income projections anticipated to be derived from the exploitation of the aforementioned transferred IP. The commensurate-with-income rules provide US taxpayers a 20% margin of error on its projections used to establish the IP price (e.g., the royalty rate). If the actual financial result from the exploitation of the transferred IP is within 20% of the original projection, then no adjustments are required. However, if the actual financial result varies from the original projections by greater than 20%, the transaction must be adjusted to reflect the actual result. Assume the same facts as above, except now assume that it is three years after the consummation of the license arrangement between Party A and Party B. Based on the actual financial result of the income derived from the licensed IP, it is determined that the price (royalty) that should have been charged by Party A to Party B is 33%. Party A and Party B will be required to adjust the royalty rate upwards to 33% as required by the commensurate-with-income rules.

In the context of a CSA, if the initial financial projections used to establish the platform contribution transaction price were determined under US GAAP, and later actual results were calculated under IFRS, differences in the revenue and expense recognition standards between US GAAP and IFRS may lead the company to erroneously conclude that the original transaction price should be adjusted. Companies may come to this erroneous conclusion simply because the financial projections and actual results were measured under two different accounting standards. To confirm whether the pre-existing IP pricing structure falls within the allowable margin of error, companies should ensure they are applying an apples-to-apples comparison when evaluating expected results to actual results. As such, companies with platform contribution transactions should evaluate and consider the impacts that IFRS adoption will have on their commensurate-with-income analysis.

<sup>1</sup> In December 2008, the Financial Accounting Standards Board and the International Accounting Standards Board jointly issued the discussion paper, "Preliminary Views on Revenue Recognition in Contracts with Customers." This discussion paper proposes changes to both US GAAP and IFRS that, if ultimately included in a new standard, would have potentially significant ramifications to revenue recognition.

## Intangible development costs

Intangible development costs (IDCs) are the pool of costs that are required to be shared between the participants of a CSA based on each party's RABs. IDCs consist of items such as operating expenses, the charge for tangible property made available to the CSA, expenses associated with internally generated intangible assets, and share-based compensation.

Currently, the rules within the US tax law state the following with respect to which costs should be considered IDCs:

*"Reference to generally accepted accounting principles or Federal income tax accounting rules may provide a useful starting point but will not be conclusive regarding inclusion of costs in IDCs."*

Based on the above excerpt, the starting point to determine which costs are to be considered as IDCs under the current US tax law may be based on financial accounting. Although many organizations today use US GAAP as their starting point to determine IDCs, the current US tax law leaves the door open for companies to utilize another financial accounting standard, such as IFRS, as long as the standard is applied consistently.

The question then arises, will utilizing IFRS to determine an organization's IDCs produce different cost-sharing results compared to US GAAP? The answer is potentially yes.<sup>2</sup> Differences currently exist between US GAAP and IFRS with respect to various expense recognition items, which could potentially lead to differences in the calculation of the IDCs.

To help illustrate how changing accounting standards (e.g., changing from US GAAP to IFRS) may impact the calculation of IDCs, consider the following: Assume there are two parties within a CSA. Party 1 incurs expenses related to share-based compensation and Party 2 does not. Assume all expenses in the IDC pool, other than share-based compensation, are treated similarly under US GAAP and IFRS. See Exhibit 1 below.

As illustrated in Exhibit 1, the expenses related to share-based compensation for Party 1 are \$100,000 under US GAAP versus \$150,000 under IFRS. As a result, the IDC percentages within this CSA would be altered upon the adoption to IFRS, which would ultimately result in a potentially different RAB share. As shown in Exhibit 1, since the total IDCs for Party 1 and Party 2 under IFRS equal \$450,000, and the costs are required to be shared equally under the CSA in this example, each party would be required to contribute \$225,000. Since Party 2 contributed only \$200,000 to the total IDCs upon the adoption of IFRS, Party 2 would be required to make a payment of \$25,000 to Party 1, so that the costs for Party 1 and Party 2 would be equal (i.e., \$225,000 each).

### Exhibit 1

	US GAAP		IFRS	
	Party 1	Party 2	Party 1	Party 2
Share-based compensation	\$100,000		\$150,000	
Other IDCs	\$100,000	\$200,000	\$100,000	\$200,000
<b>Total IDCs</b>	<b>\$200,000</b>	<b>\$200,000</b>	<b>\$250,000</b>	<b>\$200,000</b>
IDC percentages	50%	50%	56%	44%

<sup>2</sup> In 2008, the US Treasury released temporary and proposed regulations that may impact the treatment of IDCs. Companies should monitor these regulations to understand the potential impact on their IDCs.

## Other considerations

Transactions involving the sale or license of IP can have a significant impact on CSAs. When a transaction is structured as a sale, both US GAAP and IFRS eliminate, in consolidation, any gain realized from the sale. However, US GAAP and IFRS currently differ on how the tax-related impacts of an intercompany sale are recorded in the consolidated financial statements.

In March 2009, the International Accounting Standards Board (IASB) released an Exposure Draft on Income Taxes, which has the potential to affect US GAAP. If the Exposure Draft is finalized in its current state, and is adopted by US filers, the tax accounting associated with intercompany transactions will be impacted. Specifically, under the Exposure Draft, which is consistent with current IFRS, on an intercompany sale or transfer of assets, the selling company will be required to recognize the current tax expense associated with the profit on the sale or transfer immediately (i.e., in the period that the sale or transfer takes place). In addition, the buying company will be required to recognize deferred taxes upon the intercompany sale or transfer. This tax accounting model, which differs significantly compared to current US GAAP, may create a significant impact on an organization's effective tax rate in the period of the sale or transfer.

## What this means for your company

Adopting new IFRS accounting policies may have a significant impact on an organization's transfer pricing, including its CSAs. Differences between US GAAP and IFRS related to revenue and expense recognition, in particular, may have significant impacts to several key elements of CSAs, including the calculation of reasonably anticipated benefits, the application of the commensurate-with-income standard, and the determination of intangible development costs.

As companies continue to evaluate their accounting policies in connection with efforts to converge with, or convert to IFRS, it is critical that they understand the potential implications that IFRS may have on their overall financial and tax planning, including the potential impacts to their transfer pricing and CSAs. The status of IFRS reporting requirements vary significantly across many jurisdictions around the globe. US MNCs that participate in CSAs should therefore proactively plan for and manage the IFRS impacts on these arrangements to avoid surprises and maximize planning opportunities.

# Contacts

Clients of PricewaterhouseCoopers may want to open a dialogue about IFRS with their PwC engagement partner or the primary authors of this paper who welcome any questions about the tax implications of IFRS.

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For our complete list of US IFRS publications and webcasts, please visit [www.pwc.com/usifrs](http://www.pwc.com/usifrs).

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