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OECD alert
BEPS action 8: Hard-to-value intangibles: Implementation guidance for tax administrations

As part of the OECD BEPS project, the Inclusive Framework has released a Discussion Draft on *The Approach to Hard-to-Value Intangibles: Implementation Guidance for Tax Administrations*. This supplements the approach to pricing hard-to-value intangibles set out in the BEPS report on *Aligning Transfer Pricing Outcomes with Value Creation* (BEPS Actions 8-10), published on 5 October 2015.

The Discussion Draft, issued on 23 May 2017, sets out the principles for implementation of the hard-to-value intangibles approach, includes three examples to clarify the implementation of the approach, and a brief explanation of the interaction between the hard-to-value intangibles approach and access to the mutual agreement procedure (MAP) under a tax treaty.

The guidance does not represent a consensus view of the governments involved, but is intended to provide substantive proposals for analysis and comment.

The G20/OECD's work on intangibles under the BEPS project resulted in changes to the *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* in respect of newly defined hard-to-value intangibles. Hard-to-value intangibles are those for which, at the time of their transfer between group companies, no reliable comparables exist and projections of future income flows are highly uncertain. Tax authorities are concerned that, in many cases involving hard-to-value intangibles, there is information asymmetry such that tax authorities have to rely wholly on information being provided by the business, which can limit their ability to objectively evaluate pricing arrangements. The G20/OECD's approach permits the use of *ex post* outcomes to provide presumptive evidence about the appropriateness of the *ex ante* pricing arrangements.

Businesses can rebut such evidence by demonstrating that any significant differences between the financial projections and actual outcomes were either due to unforeseeable events or the playing out of probability of occurrence of foreseeable outcomes and that these probabilities were not significantly over or underestimated at the time of the transaction. There is an exemption from adjustment to pricing where the difference between the financial projections and actual outcomes does not change the valuation by more than 20%. The hard-to-value approach no longer applies after a commercialization period of five years in which the difference is not greater than 20% of the projections; and there is a further exemption where the transfer of the intangible is covered by a bilateral or multilateral advance pricing agreement.

Implementation principles

The Discussion Draft sets out principles for implementation of the hard-to-value intangibles rules:

- Where the hard-to-value intangibles approach applies, tax authorities can consider *ex post* outcomes as presumptive evidence about the appropriateness of the *ex ante* pricing arrangements.
- The *ex post* outcomes inform the determination of the valuation that would have been made at the time of the transaction. A valuation based on the actual outcome should take into account the probability of achieving such outcomes (e.g. income or cash flows) at the time of the transfer of the hard-to-value intangible.
- Where a revised valuation shows that the intangible has been transferred at undervalue or overvalue compared to the arm's length price, the revised value of the transferred intangible may be assessed to tax taking into account contingent payments and price adjustment clauses. Appropriate adjustments can include alternative pricing structures.

Tax authorities should apply usual audit practices to ensure that evidence based on *ex post* outcomes is identified and acted upon as early as possible. It is recognized that such analysis may only be possible some years after the transaction. The elapsed time between the transfer of the hard-to-value intangible and the emergence of *ex post* outcomes may not correspond with audit cycles or administrative/statutory time periods, e.g. partially developed intangibles where commercial exploitation does not begin for several years. The Discussion Draft suggests tax authorities should identify transfers of potential hard-to-value intangibles and seek information about *ex post* outcomes, even where those outcomes arise in years subsequent to those under audit, to be in a position to consider the appropriateness of the *ex ante* pricing.

Countries with short audit cycles or short statutes of limitations may consider targeted changes to procedures or legislation, e.g. the introduction of a requirement to notify the transfer or licence of an intangible falling within the hard-to-value intangibles definition, or amendment of the normal statute of limitations.

Examples

The examples set out in the Discussion Draft are aimed at illustrating the practical implementation of a transfer pricing adjustment. Each of the examples involves the transfer of hard-to-value intangibles (or rights therein).

Example 1: Commercialization of a partially developed drug occurs earlier than expected and the business cannot demonstrate that its original valuation properly took into account the possibility that sales would arise in earlier periods, or that such a development was unforeseeable. Under Scenario A, an adjustment to assess additional profits at the time of the transfer is made. Under Scenario B, no adjustment is required as the difference between projected and actual outcomes is within 20% of the compensation determined at the time of the transaction. The Discussion Draft says that an adjustment under other sections of the *OECD Transfer Pricing Guidelines* may still be appropriate.

Example 2: Sales in some years are significantly higher than projected and the business cannot demonstrate that its original valuation properly took into account the possibility that sales would reach these levels, or that such a development was unforeseeable. The tax authority makes an adjustment to assess the additional profits through a re-assessment of the price paid at the time of transfer or through an alternative payment structure such as additional contingent payments.

Example 3: Pricing calculated at the time of a transaction transferring rights in an intangible is too low and ensuing royalty payments should have been higher. The amount of the adjustment will depend on domestic law and the applicable statute of limitations.

Hard-to-value intangibles and the MAP

The Discussion Draft refers to the improvements to MAPs resulting from *BEPS Action 14: Making Dispute Resolution Mechanisms More Effective*, and the minimum standard on dispute resolution to which the countries participating in the BEPS Inclusive Framework have committed. The Discussion Draft confirms that the MAP will apply to disputes in respect of hard-to-value intangibles as it will to other treaty-related transactions.

Comments

Tax authorities are concerned about the lack of information that they have in relation to hard-to-value intangibles, and the reliance that has to be placed on information from businesses.

The Discussion Draft aims to promote common understanding and practice in applying valuation adjustments to transfers of highly uncertain intangibles. Businesses will need to expect there to be more audits and adjustments in relation to the pricing of intangibles that qualify as hard-to-value, and prepare for more cases to require resolution under MAPs.

Businesses are permitted to rebut presumptive evidence that valuation should be based on outcomes. Further clarity should be provided in the guidance setting out when tax authorities can accept that there is reliable evidence that any significant differences between forecast and actual results are due to unforeseeable developments. There are numerous examples where commercial third-party transactions have not led to the results expected for a wide variety of reasons.

It would be helpful if more examples with more complex circumstances were included. These could include scenarios where adjustments are affected by multiple year results, where cash flows fluctuate, or where the valuation decreases rather than increases. It also would be helpful if a discussion about portfolios of intangibles were included.

Any reassessment of pricing on the basis of actual outcomes should be afforded symmetrical treatment by both (or all) tax authorities, in some cases without the need for recourse to MAPs. For example, price adjustment clauses in intercompany contracts for the transfer of hard-to-value intangibles that revisit the valuation based on outcomes could be respected, such that valuations are reflected in financial statements. Without such measures, the number of MAP cases will rise significantly (and cases will potentially recur based on new outcomes) and include those where the tax authorities do not disagree on the reasonableness of the adjustment. This may cause a significant administrative burden for tax authorities, as well as compliance costs for businesses.

MAPs (and where possible, binding arbitration) will remain the most appropriate method for resolving disputes between tax authorities as to valuation or the adjustment required.

Comments on the Discussion Draft are invited by 30 June 2017.

Contacts

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