# Base Erosion and Profit Shifting (BEPS)

## Comments Received on Public Discussion Draft

# BEPS Action 8 Implementation Guidance on Hard-to-Value Intangibles

5 July 2017



BETTER POLICIES FOR BETTER LIVES

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22nd June 2017

Comments on implementation guidance on HTVI

Thank you for the invitation to comment on the discussion draft on the implementation guidance for tax administrations on hard-to-value intangibles. These comments reflect my personal views and have not been prepared on behalf of or at the request of any other person or organisation.

The approach to HTVI found in section D.4 of Chapter VI on the Guidelines is agreed and formally adopted guidance which provides an additional tool for tax administrations in carefully defined, narrow circumstances (including important exemptions) that can give rise to major problems for tax administrations in evaluating a transfer of intangibles. In essence the approach allows tax administrations to use *ex post* outcomes in assessing the appropriateness of the taxpayer's *ex ante* valuation because *ex post* outcomes may be the sole source of information independent of the taxpayer's insights and assumptions. It is an important principle of the approach to HTVI that unless unforeseeable what has actually happened must have been possible to anticipate and should be used to inform the determination of the arm's length pricing arrangements, including any contingent pricing arrangements, that would have been made between independent enterprises to address high uncertainty at the time of the transaction. Nothing in the comments below on the draft implementation guidance for tax administrations should be interpreted as questioning this important approach; instead, the comments seek to ensure that the approach is implemented effectively and its value in practice can be realised.

My comments include the following topics: inadvertent generalisation of the problem addressed by the highly targeted guidance on HTVI, the risks of appearing to concentrate on the pharmaceutical sector, the implications of some of the suggested administrative or legislative changes, some technical comments on the presentation of the examples, the unnecessarily narrow approach apparently taken in Example 3, specific further improvements to MAP, and an additional example. The implicit answer to the major question of how to deal with undervaluation in years closed to adjustments under domestic rules seems to be that contingent payment structures should be applied flexibly to enable the full adjustment to be included in open years. Such a pragmatic approach should be made explicit, and its clear adoption would likely help to ensure that access to MAP is not restricted.

## A. Stating the problem

1. In developing implementation guidance, the draft should not appear to change the underlying guidance on HTVI found in section D.4 of Chapter VI of the Guidelines. Paragraph 5 does not state the problem precisely and risks diluting the very concentrated features of HTVI. In particular, the following two sentences should be reconsidered since they have significance in serving to state the problem that is taken up in paragraph 6 and the rest of the implementation guidance: "Compared to the tax administration, the taxpayer is likely to have more information that can be used to create a valuation report at the time of the transaction that appears comprehensive and robust. The problem for tax administration is that the valuation is extremely difficult to objectively evaluate since it [the valuation report of the taxpayer or the evaluation by the tax administration?] may be wholly based on the information provided by the taxpayer." It is surely always the case that the taxpayer will have more information than the tax administration at the time of the transaction, and it is often the case that the valuation provided by the taxpayer will be based wholly on information provided by the taxpayer. Information asymmetry is a general feature of the relationship between tax administrations and taxpayers, but there is something very particular about information asymmetry in relation to HTVI.

2. The critical point about information asymmetry in relation to HTVI is that a tax administration has no means or limited means to evaluate the valuation report provided by the taxpayer independently of the insights and information provided by the taxpayer. It is this particular information asymmetry which, as the paragraph goes on to state, restricts the ability of tax administrations to establish or verify various relevant matters. Such particular information asymmetry underpins the examples: as stated in paragraph 18, the tax administration would have had little means of verifying the reasonableness of the taxpayer's assumptions relating to the level of sales anticipated at the time of the transaction.

3. The concern with the two sentences in paragraph 5 is that the meaning is not entirely clear and they tend to suggest that the problem is a general one of the taxpayer always controlling the information, and may suggest a widening of the application of the approach to HTVI, whereas the issue is a narrow one of the tax administration having no means to know whether the assumptions made in the valuation were reasonable. The following re-phrasing of the two sentences is offered in case it assists your re-consideration: "The taxpayer will likely prepare a valuation report at the time of the transaction using assumptions based on its specialised knowledge, expertise and insight into the business environment in which the intangible is developed or exploited. The problem for the tax administration is that it has no means or limited means to evaluate the assumptions used in the valuation independently of the insights provided by the taxpayer."

4. Paragraph 12 makes a very strong statement about the kinds of adjustments a tax administration might make. It ends with a vague direction to see 6.192 of the Guidelines, which itself refers to 6.185, but it does not direct the reader to what aspects of these paragraphs might be relevant. Both 6.185 and 6.192 qualify the kinds of adjustments by referring to what independent enterprise would have done in comparable circumstances to address high uncertainty. It seems that paragraph 12 should also make this important connection with the arm's length principle, and, if the inclusion of context suggested below is not adopted, the paragraph could usefully end with wording such as the following: "as established by means of an analysis of mechanisms to address uncertainty adopted by independent enterprises in comparable circumstances, taking into account all relevant facts including relevant industry practices in relation to any such mechanisms."

5. However, paragraph 12 stands out rather on its own as the only statement about the approach to adjustments and the role of contingent pricing arrangements that independent enterprises might adopt in comparable circumstances to address high uncertainty at the time of the transaction. Since contingent payments are critical in implementing adjustments in the subsequent examples (with the incorrect exception of Example 3—see later comments), a specific reminder about the context of what independent enterprises would do to address uncertainty is recommended. The following wording is offered as an illustration of context for contingent pricing terms in the examples, and may be particularly useful if the note is intended to be separate from the Guidelines, as discussed below:

> The approach to HTVI authorises tax administrations to use *ex post* outcomes as presumptive evidence about the appropriateness of the *ex ante* pricing arrangements. The taxpayer is entitled to provide evidence that any significant difference between projections and actual outcomes was either unforeseeable or results from the playing out of the probability of foreseeable outcomes reasonably taken into account at the time of the transaction (see 6.193). Unless

unforeseeable, what has actually happened must have been possible to anticipate at the time of the transfer and should be used to "inform the determination of the arm's length pricing arrangements, including any contingent pricing arrangements, that would have been made between independent enterprises at the time of the transaction" (6.192).

Section D.3 of Chapter VI of the Guidelines describes the variety of mechanisms independent enterprises might adopt to address high uncertainty at the time of the transaction. These include fixing the price based on projections which are sufficiently predictable, or, in order to provide protection against subsequent developments that might not be sufficiently predictable, independent enterprises might adopt shorter-term agreements, price adjustment clauses, or a contingent payment structure. As paragraph 6.183 notes, "For these purposes, a contingent pricing arrangement is any pricing arrangement in which the quantum or timing of payments is dependent on contingent events, including the achievement of predetermined financial thresholds such as sales or profits, or of predetermined development stages (e.g. royalty or periodic milestone payments). For example, a royalty rate could be set to increase as the sales of the licensee increase, or additional payments could be required at such time as certain development targets are successfully achieved. For a transfer of intangibles or rights in intangibles at a stage when they are not ready to be commercialised but require further development, payment terms adopted by independent parties on initial transfer might include the determination of additional contingent amounts that would become payable only on the achievement of specified milestone stages in their further development."

The conclusion reached in Section D.3 of Chapter VI of the Guidelines is critical to the implementation by tax administrations of the approach to HTVI: "If independent enterprises in comparable circumstances would have agreed on the inclusion of a mechanism to address high uncertainty in valuing the intangible (e.g. a price adjustment clause), the tax administration should be permitted to determine the pricing of a transaction involving an intangible or rights in an intangible on the basis of such mechanism." (6.185). Regardless of the payment structure adopted by the taxpayer, in applying the HTVI approach tax administrations should apply the most appropriate structure (for examples, milestone payments, running royalties with or without adjustable elements, price adjustment clauses, or a combination of these characteristics) as established by means of an analysis of mechanisms to address uncertainty adopted by independent enterprises in comparable circumstances, taking into account all relevant facts including relevant industry practices in relation to any such mechanisms.

6. The inclusion of the full context suggested above may be particularly important if the implementation guidance is intended as a note that stands outside the Guidelines. However, the location of the implementation guidance is not clear. The final sentence of paragraph 23 is one example of several references to THESE Guidelines, references which indicate that the implementation guidance is intended as part of the Guidelines. In other parts of the implementation guidance, references are made to THE Guidelines with the implication that the implementation guidance will be a separate document. What is the intention? It seems to me that a note directed towards tax administrations, and one which in its current form suggests tax administrations may need more experience to inform the direction of the guidance, may be better framed as a separate note and not incorporated in the Guidelines. If the intention is to include the implementation guidance in the Guidelines, then an option might be to limit the note to examples without any further commentary, and add them to the examples already appended to Chapter VI.

7. The third bullet of paragraph 13 reinforces aspects of paragraph 12. However, in this third bullet, the reference to an intangible transferred at undervalue "or overvalue" requires further consideration and explanation. The guidance as a whole tends to be written in general from the perspective of a tax administration examining the transferor and making upwards adjustments to the initial valuation, perhaps through additional contingent payments. A transfer at overvalue must, it appears, relate to a tax administration examining the transferee which has overpaid for the intangible. However, this scenario does not fit well with the rest of the sentence: how can the overvaluation be addressed by taking into account contingent payments and price adjustment clauses? There would need to be a determination, for example, that the initial payment or series of recurring payments was overstated, and would have been at a higher level only if certain milestones or results were achieved. However, the revised value can only be assessed to tax by reducing these initial payments or by implementing some form of rebate or negative royalty, a concept which is not discussed (but is similar conceptually to the point about rebate or discount that I raise in paragraph 21 of these comments). If the reference to "or overvalue" is retained, then some explanation of how adjustments are implemented for the enterprise making the over-payment should be provided.

## B. Apparent concentration on pharmaceutical sector

8. The concentration of the examples on the pharmaceutical sector risks giving the impression that the approach to HTVI is directed at drug companies. In fact, the regulated nature of the pharmaceutical industry, together with strong interest from investors in pipeline progression, means that there are well-defined development stages, independently documented information on success rates across and within therapeutic categories, and there can be contemporaneous public information about the target market and anticipated sales. As a result, information asymmetry contemplated in the approach to HTVI can be less of a problem in the pharmaceutical industry than in a sector which does not define stages of development so rigorously, for which success rates are not available, or for which the target market is not so clear. It is suggested later in these comments that there could be an additional example, or, given the comments below, that Example 3 could be framed as referring to a different sector.

9. The concentration on the pharmaceutical sector in the examples can give rise to potential misinterpretations of the draft guidance. The reference in paragraph 8 to intangibles that have long incubation periods picks up just one of the several likely features of HTVI, but there is a risk that it will be interpreted as meaning that all drug development falls within HTVI. In fact, the longer the incubation period, the less likely the intangible transferred may prove to be hard to value in some circumstances. For example, a pharmaceutical compound transferred at a very early stage in development (perhaps at the point of discovery but before any clinical development) may not be exploited commercially, if at all, for ten years. However, if the transferee is responsible for taking the compound through clinical development during those ten years, then significant costs and development risks were undertaken by the transferee and not by the transferor. In such a case, the original transfer may not give rise to significant uncertainties in valuation or in information asymmetry. In contrast, a drug transferred at Phase III and exploited within a relatively short incubation period of three years, may give rise to much greater uncertainties and information asymmetry notwithstanding the shorter period. Such a clarification, if considered appropriate,

would help reduce the risk of misunderstandings arising from the concentration on examples of pharmaceutical development.

## C. Administrative or legislative changes

10. Paragraph 11 suggests some administrative or legislative changes that countries may consider introducing. The suggestions are only briefly mentioned, but their implications do not seem to be considered and in some cases their effectiveness is doubtful. One suggestion is for the introduction of a requirement to notify promptly the transfer of an intangible falling within the HTVI definition. However, what will a tax administration then do with the disclosure given the practical difficulties acknowledged in paragraph 7? It is unlikely it will be in a position to know the valuation is satisfactory since it is a feature of HTVI that *ex post* outcomes prompt scrutiny of the taxpayer's insights and assumptions. For the same reason, the tax administration is unlikely to be in a position to know the valuation is unsatisfactory. Such disclosure could only serve the purpose of allowing the tax administration to keep the transfer under review, or to perhaps indicate its view that contingent payments in the future might be appropriate, but for that purpose, given the enhanced documentation requirements relating to intangibles, a separate reporting requirement does not seem necessary. On the other hand, a separate notification might be useful for tax administrations when it becomes apparent that exemption (iii) in 6.193 no longer applies; that is, when reliance can no longer be placed on the 20% tolerances.

11. A second suggestion found in paragraph 11 is for amendment of the normal statute of limitations. This may be relevant for countries that have short audit cycles and relatively quick closure of the window allowed for adjustments. However, such an amendment must follow through to any bilaterally agreed time limitations on the operation of the Mutual Agreement Procedure under bilateral treaties, so that the MAP remains accessible and effective notwithstanding that the adjustment has been made outside normal time limits and a change has been made to the time limits that would have been taken into account when negotiating and agreeing the specific terms of the bilateral MAP provisions. See also the comments on paragraph 30 and the associated footnote.

## D. Examples

12. In paragraph 20, the second sentence should be revised to read: "The taxpayer's original valuation is revised to include the possibility of sales being projected in earlier years, resulting in . . ." in order to seek to avoid the implication that the actual sales are automatically used in the revised valuation. A similar change should be made in paragraph 22. Similarly, in paragraph 25 the wording should be revised to read: "The taxpayer's original valuation is revised to include the possibility of higher sales being projected . . . ."

13. The note at the end of paragraph 20 (and also at 22 and 25) is presumably intended to emphasise that the valuation should not be based on actual outcomes without taking into account the probability of those outcomes arising at the time of the transfer. However, the wording is odd since it seems to suggest that the revised value could be based on actual outcomes, contrary to agreed guidance, but is not necessarily so. Perhaps the notes could be reworded as: "Note that the value of xxx is based on the net present value of the transferred rights derived from the actual outcomes

and taking into account an assessment of the probability at the time of the transaction of those outcomes being achieved."

14. These two comments highlight the fact that the implementation guidance does not indicate how the tax administration should assess probability. It is premised that the outcome was not unforeseeable, and that therefore it was possible to foresee the outcome. However, there is no guidance about the appropriate probability weighting. It is perhaps too challenging in an example to provide detailed guidance on assessing probability, but it could be useful to state the principle that in assessing the probability of the particular outcome or outcomes being achieved at the time of the transaction, tax administrations should take into account subsequent developments or events that contributed to the difference between projections and outcomes and any evidence about their likely occurrence.

15. The final sentence of paragraph 23 is curious. This sentence seems to state that even though an exemption from the approach to HTVI applies, an adjustment under other sections of the Guidelines may be appropriate. Why is this the case? Have reliable comparables emerged, even though it is premised that there are none? Or is it that evidence might emerge that the taxpayer knew sales would arise in earlier periods, and so the valuation was based on incorrect assumptions and was erroneous and potentially negligent. As a result, the exemption from the approach to HTVI still applies with the result that *ex post* outcomes cannot be used as presumptive evidence to assess the appropriateness of the *ex ante* valuation, but in fact the *ex ante* valuation can be shown to be incorrect based on what the taxpayer knew at the time. If this is the intended meaning, it is not clear what other sections of the Guidelines may be relevant.

16. The guidance in paragraph 29 is correct in principle, but would benefit from further guidance since it touches on a major implementation issue that has not been addressed. This paragraph envisages that there could be two audits of the same taxpayer in different periods as outlined in the examples, with adjustments in both audits arising from different *ex post* evidence emerging at different times (evidence of sales in years earlier than projected emerging in Year 4 on audit of Years 0-2 resulting in an adjustment in Year 0, and then evidence of higher levels of sales than projected emerging in Year 7 on audit of Years 3-5 resulting in an adjustment in Year 3). However, the paragraph also envisages that there could be only a single audit carried out in Year 7, which discovers the *ex post* evidence of both earlier sales and higher sales. Until this point, the examples have been carefully constructed to allow the adjustment to be made in the audit period, and therefore to avoid difficult questions about closed years. However, the possibility envisaged in this paragraph that the audit of Years 3-5 in Year 7 can also make adjustments in Year 0 may, in certain situations, conflict with closed years. It is probable that the guidance does not intend to mean that there should be an adjustment in Year 0, but rather seeks to explain that if there is only one audit, a contingent adjustment should be made in Year 3 taking into account both reasons for undervaluation at the time of the transfer. In other words, the guidance seeks to state that the total undervaluation should be recovered within the audit period and taking into account the pricing mechanisms independent parties would have agreed in comparable circumstances to address the high uncertainty revealed by the *ex post* evidence. Recovering the undervaluation within the audit period is an important issue (implicit until this point in all the examples) for implementation, particularly in reducing potential problems that might otherwise be encountered in accessing MAP for years that might be time-barred.

17. Example 3 in paragraph 30 is problematic since it seems to overlook other aspects of the guidance, and risks creating a different outcome depending on whether the taxpayer has presented the transaction as a lump sum payment or a price based on recurring royalty payments. Example 3 seems to conclude that the required adjustment must be recovered through royalty payments, presumably on the questionable basis that the taxpayer has characterised the terms as royalties, and further that the adjusted royalties should be allocated to all years. As a result, in this example there is a prospect that not all of the undervaluation may be recovered since some of the additional royalty payments may relate to years which may be closed to adjustment. Such an approach is unnecessarily narrow.

18. Other aspects of the implementation guidance, in accordance with the Guidelines, state that the revised value should be assessed irrespective of the payment profiles asserted by the taxpayer. Regardless of the payment structure adopted by the taxpayer, in applying the HTVI approach tax administrations should apply the most appropriate structure (for examples, milestone payments, running royalties with or without adjustable elements, price adjustment clauses, or a combination of these characteristics) as established by means of an analysis of mechanisms to address uncertainty adopted by independent enterprises in comparable circumstances, taking into account all relevant facts including relevant industry practices in relation to any such mechanisms. Example 3 seems to conclude that the only adjustment that can be made is to increase the fixed rate of running royalties for all years of the agreement. However, it is not uncommon for third-party arrangements to combine royalties with milestone payments or other contingent elements that would likely be appropriate in this example. Furthermore, the example lacks flexibility in not recognising that the royalty element itself could be variable, and could be set at a higher level as sales increase. If the example were to adopt the principles of other aspects of the implementation guidance and of the Guidelines, it would avoid the apparent inflexibility and would be able to encourage tax administrations, as is implicit in the other examples, to make the full adjustments in open years under normal time limits. The example should be rephrased to recognise that different payment structures can be adopted and that adjustments making full recovery can be made in the audit period and not necessarily for all years, and it should delete the sentence referring to the statute of limitations and the associated footnote.

19. Such an implicit principle should be elevated to an explicit principle in the guidance so that tax administrations, in applying the most appropriate payment structure to address uncertainty adopted by independent enterprises in comparable circumstances, are expressly encouraged to apply a structure that enables appropriate adjustments to be made in open years under normal time limits. This approach will help to reduce the risk that access to MAP will be denied in full or in part. In addition, paragraph 31 should expressly encourage flexibility to allow the competent authorities to agree a different payment structure to that adopted on audit if, by so doing, the adjustment can be fully considered under MAP. This seems to be a more practical way of accessing effective MAP than that envisaged in the footnote to paragraph 30, recommended in these comments for deletion. That footnote seems to suggest that the country making the primary adjustment under its domestic rules would limit the adjusted years if the country being invited to consider a corresponding adjustment could not itself have made a primary adjustment for any of the adjusted years under its domestic rules. Such a suggestion, if properly understood, seems inefficient (the audit would likely still proceed to conclusion, and competent authority discussions may require detailed hypotheses about a treaty partner's domestic audit powers) and differs from the BEPS 2015 Final Report for

Action 14, *Making Dispute Resolution Mechanisms More Effective,* in which it was recommended that there should be no time limits for making a corresponding adjustment or, where this is not possible, to include bilaterally agreed time limits on the making of the primary adjustment (section 3.3, paragraphs 38-41). Paragraph 32 requires the implementation guidance to be read in conjunction with that Report, a requirement that may make the apparent difference on this point difficult to interpret.

20. The expression of the exemption at the end of Example 3 requires reconsideration since it does not accurately reflect the exemption in 6.193 (iii). In this example, the royalty was set to recover an intangible value of 700 on anticipated sales of 3500, whereas the adjusted value has been determined to be 1300 because of significant differences between financial projections and actual outcomes that are not attributable to unforeseeable developments or events or to the playing out of the probabilities of foreseeable development or events that were reasonably evaluated. The exemption in 6.193 applies if those significant differences do not have the effect of revising the compensation for the HTVI by more than 20% from the compensation determined at the time of the transaction. Under a lump sum arrangement, the significant differences do have the effect of revising the compensation for the HTVI by more than 20% since those differences increase the valuation to 1300 from 700. However, because the compensation is recovered through recurring royalties on sales, the original royalty rate has been applied to earlier and higher sales than anticipated and the resulting royalties paid may, therefore, contribute to increasing the compensation for the HTVI. For example, the compensation from royalties of 20% by Year 5 may have a Year 0 value of, say, 1100, without any change to the royalty rate. Therefore, the compensation determined at the time of the transaction is 1100. The significant difference between financial projections and actual outcomes does not have the effect of increasing the compensation for the HTVI (1300) by more than 20% of the compensation determined at the time of the transaction (1100). The way the final sentence expresses the application of the exemption is misleading because it compares the compensation actually received (in my example 1100) with the compensation "anticipated at the time of the transaction," which remains at 700. The exemption will not work as intended if it is interpreted as requiring a comparison with the amount of compensation anticipated at the time of the transaction. The final sentence should use the wording of the exemption more precisely and should be revised to read: "Exemption (iii) in paragraph 6.193 of Chapter VI of the Guidelines may be relevant because the compensation determined at the time of the transaction, a royalty rate of 20% of sales, may have produced, when applied to the earlier and higher sales than projected, an amount of compensation, that expressed in Year 0 values and with 20% added, is not less than the revised valuation of 1300."

## E. Outline of additional example

21. As mentioned earlier, the concentration of examples in the pharmaceutical sector can create unfortunate perceptions. Example 3 could be converted to a non-pharma example, to provide some balance, or better still, an additional non-pharma example could be added. For instance, the following example can also be used to support flexibility in adjusting royalty arrangements so that adjustments are made in the audit period, and also perhaps provides a useful variation in that it does not necessarily depend on a discounted cash flow valuation technique. Features of this example could also help in providing some guidance on assessing the likely occurrence of subsequent developments or events. The example undoubtedly could be improved and is offered in case it

helps to stimulate further consideration. Note that at the end there is a phrase which may not be fully appreciated or welcomed: “any royalty discounts that could reasonably have been concluded to have been granted in Years 0-3.” The draft implementation guidance shies away from dealing with adjustments that potentially are perceived to belong to closed years. One way of dealing with this, as discussed in these comments, is explicitly to encourage flexibility in adopting contingent pricing structures that belong to the audit period. Another way is to recognise what has actually happened in the closed years as a discounted or rebated price for a period, the terms of which could have implications in considering the pricing, including anticipated recovery of the discount, in the later period under audit. Such arguments are made in practice, and it would be helpful if the guidance could provide firmer direction on this major issue.

> Company T, a resident of Country T, specialises in developing technology used mainly in creating new materials used in a variety of engineering applications. Company T has developed a pioneering technology that has never before been commercialised. Such technology can be incorporated in every-day clothing and accessories, a new market for Company T. Company T has patented this technology and licenses rights to the technology under a ten-year agreement to Company M, an associated company, in Year 0. Company M, a resident of Country M, manufactures and distributes apparel products incorporating the technology developed by Company T. Based on the profit potential for Company M from anticipated volumes of product sales incorporating the technology, and Company T's experience in licensing technology to engineering clients, the parties agree a fixed royalty rate of 10% on sales from products using the technology.
>
> Assume that the facts in the previous paragraph become known to the tax administration in Country T in Year 8 when it commences an audit of the Company T for Years 4 to 6. Even if the tax administration of Company A had been aware of these facts in Year 0 relating to the transfer of the rights, it would have had no independent means of verifying the assumptions made about profit potential and anticipated volumes of sales used in the determination of the royalty rate.
>
> The tax administration further discovers during the audit that there are significantly different outcomes in respect of sales of products using the licensed technology to those projected at the time of the transaction in Year 0.
>
> Under the guidance for HTVI, the tax administration is entitled to consider *ex post* outcomes as presumptive evidence about the appropriateness of the *ex ante* pricing arrangements, and to determine the contingent pricing arrangements that would have been agreed at the outset. The taxpayer is unable to show that the higher than projected sales resulted from unforeseeable events or that the possibility of higher sales was appropriately taken into account in the valuation. The taxpayer cannot simply assert that the determination of the price at the time was the best estimate of sales, since the approach to HTVI requires the consideration of the presumptive evidence of *ex post* outcomes in assessing the appropriateness of the *ex ante* valuation. The taxpayer asserts that the high sales volumes were the result of the unexpected success of celebrity sponsorship and the featuring of the clothing in popular films. However, such possibilities are a typical marketing feature in the industry and were not taken into account in determining the 10% royalty at the time of the transaction. In accordance with the approach to HTVI, independent enterprises in comparable circumstances would protect against the high

risks of uncertainty evidenced by the *ex post* outcomes by adopting a variable royalty arrangement from the outset of the arrangement, with higher royalties for higher level of sales.

In the facts of this example the tax administration is entitled to make a transfer pricing adjustment in Year 8 for the audit period Years 4-6 by increasing the royalty rate by reference to levels of sales. The variable royalty rates and sales levels to which they apply would be determined in accordance with the specific circumstances including the profit potential of Company M, any royalty discounts that could reasonably have been concluded to have been granted in Years 0-3, and taking into account information about pricing arrangements between independent parties in comparable circumstances.

Thank you for considering these comments. I should be happy to discuss any points you think may merit development.

With best wishes

Andrew Hickman

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June 29, 2017

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Sent via e-mail: TransferPricing@oecd.org

Re: Proposed Discussion Draft — Transfer Pricing — Implementation guidance on hard-to-value intangibles ("HTVI")

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Dear Messieurs & Mesdames,

These comments are presented by the Arthur Cox, Chiomenti, Cuatrecasas, GIDE, Gleiss Lutz, Homburger and Macfarlanes following the call for Public comments by the OECD, as it welcomes remarks and observations on the Public Discussion Draft which provides guidance on the implementation of the approach to pricing transfers of hard-to-value intangibles described in Chapter VI of the Transfer Pricing Guidelines.

This call for comments follows the Final Report on Actions 8-10 of the BEPS Action Plan ("Aligning Transfer Pricing Outcomes with Value Creation") mandated the development of guidance on the implementation of the approach to pricing hard-to-value intangibles ("**HTVI**") contained in Section D.4 of Chapter VI of the Transfer Pricing Guidelines.

We welcome this opportunity to express our views and opinions on the Public Discussion Draft, as this open and transparent process will hopefully provide the OECD with diverse point of views, leading to efficient and balanced guidance on how to price HTVI.

**Introduction**

We are fully conscious that there is a legitimate need to protect tax administrations from the negative impact of information asymmetry between tax administrations and taxpayers in valuing the transfer of HTVI. On the other hand, there is a legitimate need for legal certainty on the part of taxpayers that diligently follow the Transfer Pricing Guidelines (i.e., we need to protect *bona fide* taxpayers) must be safeguarded from unjustified enquiries into the treatment of HTVI as a gateway to potentially endless tax audits.

**Commentary**

General Comments

The main legal risk regarding the treatment of HTVI is consistency in the application of the HTVI approach by tax administrations and the risk of double taxation, thus putting a heavier burden on taxpayers to document and defend the pricing of HTVI transactions; this obviously results in ever more complex valuations and higher costs and fees.

A precise definition of the circumstances of "objective evidence" which would be required for a taxpayer to demonstrate that the original valuation performed properly considered all the available data at the time of the HTVI transaction is one of the most fundamental issues in this respect. The scope for the use of "look backs" by tax authorities should be limited, specific and clear.

It is of utmost importance for the taxpayers to be provided with specific guidelines in order to comply with the valuation of HTVI upon transfer. The use of ex post data should therefore also be grounded on objective and verifiable information and data, publicly available also to taxpayers.

It is our recommendation that a HTVI assessment using *ex-post* information should only take place if all the affected tax authorities have agreed on such an assessment, while providing the taxpayer with the opportunity to defend its case and present counter-arguments on the issues raised.

Specific Comments

As commonly known, the risk of double taxation is a top priority for taxpayers. Efforts were made to improve the effectiveness of MAPs, however, the MAP process remains one in which countries shall endeavor, without any legal commitment, to resolve double taxation cases.

Further, not all countries that may adopt the new HTVI approach will have committed to the mandatory binding arbitration process proposed under Action 14 of the G20/OECD BEPS Action Plan. This is a key point which must be tackled by the OECD. An approach that could be put forward would consist in denying the possibility to use the new HTVI approach in the absence of a certain standard of dispute resolution practices.

The examples given by the OECD in the Discussion Draft do not present a complete picture, as they simply focus on illustrating when *ex post* presumptive considerations apply, but fail to precisely lay out guidance as to what sort of *ex ante* evidence is sufficient to halt a tax authority from asserting *ex post* considerations. This leads taxpayers to wonder what sort of limitations would be applied to reign in unreasonable adjustments on the part of tax authorities.

Joint audits would ensure legal certainty for the taxpayer, as it would guarantee fair treatment of the tax situation. Joint audits should afford sufficient flexibility to taxpayers to address TP documentation in an efficient manner, so that the tax administrations receive comprehensible information on the case under scrutiny.

Especially in the context of HTVI transactions, the safeguard of the confidentiality of the information is a top priority. In addition, tax administrations should also ensure that assessments of HTVI transactions be performed by specially trained and experienced tax officers.

It appears, and based on the various legal risk involved, that *ex post* considerations should only be applied within the context of a MAP/Joint Audit, and only when all the tax authorities agree. In other words outside of a MAP/Joint Audit, *ex post* consideration should not be used on a presumptive basis, but rather as a risk assessment tool leading to an audit.

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Lastly, answers to the following questions in relation to the tax administration's anticipated use of the look back approach appear necessary:

- Who will have the ultimate authority to determine whether the evidence provided by the tax payer is appropriate / sufficient to rebut the presumptive assumption?
- What exact tests will be applied to establish whether the evidence provided was appropriate? How will these tests be applied?

**Conclusion**

We hope that these comments shed light on a few important points that could be introduced in order to facilitate the implementation of the of the approach to pricing HTVI contained in Section D.4 of Chapter VI of the Transfer Pricing Guidelines.

A smooth and efficient implementation of the approach to pricing HTVI contained in Section D.4 of Chapter VI of the Transfer Pricing Guidelines is key for all parties involved, as the repercussions will be multi-layered with the taxpayers at the forefront of them, while the tax administrations will need to adjust the implementation in a way that these additional resources are used with the utmost diligence. We trust the implementation will be carried out in an unvarying and consistent manner, so that taxpayers know and identify exactly what is to be expected going forward.

Finally, we reiterate that we truly welcomed this opportunity to provide comments on important issues that affect so many taxpayers worldwide.

Sincerely,

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Ms. Aisling Burke**, Arthur Cox**

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**STRICTLY CONFIDENTIAL**

29 June 2017

**OECD Discussion Draft under BEPS Action 8: Implementation Guidance on Hard-to-Value Intangibles**

We welcome the opportunity to comment on this discussion draft and are pleased to provide our comments below.

This guidance is of particular relevance to the pharmaceutical industry as significant differences often arise between financial projections and actual outcomes given the long time horizons for development and commercialisation of a pharmaceutical product, and occurrence of unforeseeable value-sensitive events such as patent extensions and competitors' products failing.

We have a general concern that tax administrations' ability to use *ex post* outcomes as presumptive evidence about the appropriateness of *ex ante* transfer pricing arrangements for HTVIs will create significant uncertainty and may lead to unnecessary challenges and audits over an extended period if the guidance on implementation is not carefully considered.

In particular, whilst it is noted that the discussion draft does not require tax administrations to amend domestic tax law to extend statute of limitation periods, paragraph 11 of the guidance could encourage tax administrations to create open-ended periods to consider *ex post* outcomes for HTVIs with long commercialisation periods, which could result in a large number of years open to audit across different tax jurisdictions at any one time.

This concern is exacerbated by the likelihood that tax administrations would only use this guidance to adjust pricing of HTVIs based on *ex post* outcomes if it is to their benefit (i.e. the tax authority for a transferor company is unlikely to seek an adjustment if the *ex post* outcomes require a lower value be placed on the HTVI) and, as the discussion draft notes, there may be difficulties in obtaining corresponding adjustments due to differing statutes of limitation and differing domestic rules relating to closed tax years. Whilst it is noted the Final BEPS Report for Action 14 describes a minimum standard on dispute resolution which is intended to help alleviate such problems, this does not require mandatory mutual agreement procedure arbitration and so corresponding relief would not be guaranteed.

We would therefore request that the OECD reconsiders its position regarding the use of ex post outcomes or, at a minimum, ensures the guidance provides that tax administrations should only adjust pricing based on ex post outcomes where the affected parties can obtain corresponding adjustments under relevant tax treaties or domestic law (i.e. there should be an onus on the relevant tax administrations to eliminate any double taxation that may arise as a consequence of their decision to apply *ex-post* analysis).

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Notwithstanding the above, it is acknowledged that information asymmetry is a challenge for tax administrations for which an appropriate solution is required. To achieve this whilst minimising the uncertainty highlighted above, it is thought the implementation guidance should place more emphasis on ensuring appropriate efforts are made by the taxpayer *ex-ante* to avoid information asymmetry rather than placing the emphasis on tax administrations tackling information asymmetry *ex post*.

This may be achieved by the guidance requiring taxpayers to provide adequate disclosure to tax administrations to support the valuations used, either at the time of the transaction via a form of advance clearance or as a mandatory part of the relevant corporate tax returns, and specifically providing that an adjustment could only be made based on *ex post* outcomes where the taxpayer has failed to provide such disclosure. An adequate disclosure may include evidence that all possible *ex post* outcomes have been considered (e.g. full disclosure of probability adjusted valuation models with appropriate qualitative comments on the parameters of the models, including notes on possible upsides which have not been modelled).

In addition to the more general comments made above, we have two further specific comments on the guidance in cases where tax administrations were to seek a transfer pricing adjustment based on *ex post* outcomes:

Firstly, we would request that the guidance provides for the ability of the taxpayer in such circumstances to apply similar principles to other HTVI transactions undertaken in the same tax jurisdiction within a reasonable time period to set-off against the adjustment required by the tax administration (i.e. a form of consequential amendment).

Secondly, it is noted the discussion draft requires any transfer pricing adjustments should take into account contingent payments and price adjustment clauses. Whilst we would agree that many HTVI transactions in the pharmaceuticals industry between third parties include payment structures including both sales and regulatory approval milestones, such payment terms may be dictated by the taxpayer's circumstances and preferences (e.g. the cash flows of both parties, other assets in the pipeline etc.) rather than just being a valuation matter, and hence any adjustments on related party transactions would need to be considered in the same context.

We trust the above provides useful input into the discussion draft. Please do not hesitate to contact me if you would like any clarification of the comments made.

Yours faithfully

**Alistair Collins**
**VP Corporate Finance**

The **BEPS** Monitoring Group

**COMMENTS ON**

**Public Discussion Draft: BEPS Action 8 - Implementation Guidance on Hard-to-Value Intangibles**

These comments have been prepared by the BEPS Monitoring Group (BMG). The BMG is a network of experts on various aspects of international tax, set up by a number of civil society organizations which research and campaign for tax justice including the Global Alliance for Tax Justice, Red de Justicia Fiscal de America Latina y el Caribe, Tax Justice Network, Christian Aid, Action Aid, Oxfam, and Tax Research UK. These comments have not been approved in advance by these organizations, which do not necessarily accept every detail or specific point made here, but they support the work of the BMG and endorse its general perspectives. They have been drafted by Jeffery Kadet, with comments from Tommaso Faccio and Sol Picciotto.

We are grateful for the opportunity to submit comments on this public discussion draft "BEPS Action 8 - Implementation Guidance on Hard-to-Value Intangibles".

## GENERAL REMARKS

### The Approach Adopted

The transfer of intangible property rights to related entities is one of the main techniques used by multinational enterprises (MNEs) to avoid taxes through base erosion and profit shifting (BEPS). Such assets are especially hard to value if they are transferred at an early stage, since their income-generating potential will be speculative, although best known to the firm itself. The three examples in the discussion draft all involve a transfer of such rights that have been only *partially developed*. Specifically, the examples involve a patented pharmaceutical compound that is partially through its clinical trials.

In the absence of acute economic duress or some very significant and identifiable business reason (e.g. for risk sharing, or if the transferee has a significant distribution network not possessed by the transferor), an entity (such as Company A in the examples) developing intangible rights within its core business would virtually never transfer all or any portion of those rights to unrelated persons. These are most typically core products that would be considered "crown jewels". The lack of real third-party transfers of such rights is one of the reasons why the "no reliable comparables" condition of paragraph 6.189 will virtually always be met.

While MNEs are very resourceful and creative in providing important business reasons for their tax structuring, the reality virtually always is that the sort of transfer included in the three examples has no purpose other than BEPS. Further, there are seldom any substantive operational changes that accompany such transfers.

Hence, this discussion draft (DD) rightly assumes the sad reality of "information asymmetry" and its negative effects. It provides clear and simply-stated guidance that allows taxpayers and tax authorities to identify matters requiring additional research and thinking. An example of this is the suggestion in paragraph 27 that tax authorities should consider, when appropriate, possible alternative payment structures.

We have set out below in the Specific Comments section a number of suggested additions that would be useful to both tax administrators and taxpayers alike, but which would allow retention of the discussion draft's concise and easy-to-understand approach.

### Avoiding "Legitimising" BEPS Structures

As noted above, the examples involve a transfer of intangible rights that have only been *partially developed*. It was also stated that entities developing intangible rights within their core business such as that in the three examples would virtually never transfer all or any portion of those rights to unrelated persons. Without question, the examples involve a BEPS-motivated transfer, but the examples describe it as if it were any other intercompany business transaction.

Our concern is that this approach effectively legitimises, in the mind of the reader, BEPS motivated structuring.

Admittedly, our worldwide legal and tax system provides MNEs with full entity and contractual freedom, allowing MNEs to create at their discretion new legal entities, transfer assets, and enter into any intercompany transactions which they so desire. While our system allows this, guidance such as this discussion draft should not be describing BEPS planning in any manner that legitimises it.

In order to avoid legitimising such planning, we suggest adding a statement at the end of paragraph 17 such as the following, which would be included as a parenthetical:

> Since such a transfer of partially developed rights to a drug is a transaction not likely to be found between unrelated parties in the absence of acute economic duress or some very significant and identifiable business reason, it invites close tax authority scrutiny.

## SPECIFIC COMMENTS

### Dealing with the 20% "Safe Harbour"

In Example 1 Scenario B, the taxpayer failed to properly take into account the reason for differences between financial projections and actual outcomes. Because of the percentage amount of this difference (under 20%), the exemption provided by Exemption (iii) in paragraph 6.193 ensures that the HTVI approach does not apply (though an adjustment under other sections of the Guidelines may be appropriate).

Knowing the manner in which many MNEs "craft" their structuring and transfer pricing to meet what are effectively "safe harbours", which can be in percentage or absolute terms, we believe that the use of the 20% factor in paragraph 6.193 merely incentives tax-motivated transfers of intangibles that considered this 20% when setting the price at the time of the transfer. We understand that this HTVI discussion draft is not asking for recommendations regarding settled language in the Guidelines. Recognizing this, we suggest that the following change be made in Example 1 Scenario B. We recommend that the second paragraph of Scenario B read as follows:

> 23. In accordance with the approach to HTVI, the tax administration is entitled to make an adjustment to assess the additional profits of 100 in Year 0. Note that item (iii) of paragraph 6.193 may apply in any case where the adjustment to the compensation for the transfer is within 20% of the compensation determined at the time of the transaction. In this example, in the absence of evidence that the taxpayer set its pricing taking into account this 20% factor, the exemption provided by item (iii) applies since the adjustment to the compensation for the transfer is within 20% of the compensation determined at the time of the transaction. Notwithstanding that the HTVI approach does not apply, an adjustment under other sections of these Guidelines may be appropriate.

Similarly, the following should be added at the end of Example 3 (paragraph 30):

> A tax authority may determine that Exemption (iii) in paragraph 6.193 would not apply if there is evidence that the taxpayer set its royalty rate taking into account this 20% factor.

**Guidance Concerning Transaction Characterisation**

Following on from these points, the discussion of the examples should add guidance that the conduct of the related parties must be considered in light of the transfer of intangible property. The contractual form need not be simply accepted at face value.

For example, the facts of the example (paragraph 17) state that Company S will be responsible for the Phase III trials following the transfer. However, this begs the questions: are the personnel responsible for the product's development and its testing up to the point of transfer (presumably Company A's employees or its independent contractors) still in charge? Or, has there been a full and complete hand-off to an already existing, independent, and discrete Company S management that is capable of managing the relevant risks?

The reality is that in related party situations where the primary focus is BEPS planning, there will virtually never be any full and complete hand-off.

Guidance should be provided that directs taxpayers and tax authorities to section D.2. of Chapter I of the Transfer Pricing Guidelines.

**Guidance Concerning Capacity of Transferee**

Although these three examples do not involve cost contribution arrangements, the discussion draft would provide some particularly useful guidance by referencing some of the concepts covered in some detail in Chapter VIII of the Transfer Pricing Guidelines. In particular, section C.2. (paragraphs 8.14 – 8.18) makes clear that a group member can only be a participant in a CCA if it in fact benefits from the objectives of the CCA activity. This is in contrast to only benefiting from performing the function, which in the discussion draft's examples is the Phase III clinical trials. Further, the group member cannot be a participant if it does not exercise control over the specific risks it assumes under the CCA and does not have the financial capacity to assume these risks.

Since these concepts so well articulated in respect of CCAs (and which arise from the principles covered in Chapter I) apply equally to intercompany transfers of intangible rights, the guidance should refer to section C.2. of Chapter VIII. If the transferee of the intangible rights would not be qualified to be a participant in a CCA with the transferor, then it would equally not be qualified to be treated as the owner of those rights.

**Additional Analytical Tools**

This discussion draft clearly acknowledges, but fails to adequately address, the endemic and serious problem of information asymmetry between a tax authority and a company. We have previously recommended that this issue could be addressed through a reversal of the burden of proof, with a presumption that any intra-firm transfer of HTVIs should be subject to pricing based on subsequent consideration of the actual income produced, unless the taxpayer can show that specified criteria were satisfied. We also proposed two additional criteria for such a showing: proof that the transfer did not result in a significantly lower effective tax rate, and a 'purpose test' requiring satisfactory evidence of the legal and commercial reasons for the transfer. Such a clearly stated reversal of the burden of proof would create a much stronger incentive for firms to cease tax-motivated transfers of intangibles.

Although the October 5, 2015, Final Report for Actions 8-10 did not include this specific suggestion, we recommend that as additional guidance for taxpayers and tax authorities, the examples suggest these two tools to help in the evaluation process:

- An objective analysis determining whether the transfer resulted in a significantly lower effective tax rate for the MNE as a whole, and
- A 'purpose test' critically analyzing the stated legal and commercial reasons for the transfer.

**Guidance Concerning the Profit Split Method**

Work on the profit split method is, at this time, still ongoing. Irrespective of the outcome of that work, it should be recognized that this sort of intangible property transfer will often be a strong candidate for application of the profit split method. Hence, the examples should simply note the fact, perhaps in paragraph 27, that the profit split method is an additional approach that should be considered in determining how to deal with the risks posed by the high uncertainty in valuing the intangible property.

**Case Study Addendum**

We suggest that consideration be given to adding a training addendum that could provide more detail for both the matters already referred to in the examples as well as to the various additional items that we have included in this letter. Using an addendum would retain the concise nature of the discussion draft while providing more detail for those desiring it.

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**BEPS Action 8: Implementation Guidance on Hard-to-Value Intangibles**

Dear Sir or Madam,

BDI* refers to the OECD Discussion Draft "Implementation Guidance on Hard-to-Value Intangibles" issued on 23 May 2017. Hard-to-Value Intangibles (HTVI) are a frequent source of international tax disputes, leading to double taxation. This situation is especially worrisome as HTVI are a core feature of the digital economy. We would therefore like to thank you for the opportunity to provide our comments that allow us to engage with you on these important issues. We have limited our comments to some general issues of the Draft.

The Discussion Draft describes a method in which tax administrations would be able to consider ex post outcomes as presumptive evidence regarding the appropriateness of the ex-ante pricing arrangements. This would enable tax authorities to use the ex post outcomes to revise the original transfer value of the HTVI several years after the transfer has taken place. BDI is concerned that this approach leads to tax uncertainty for businesses during several years following the transaction and fosters a discretionary interpretation of the adequacy of respective valuation cases by the tax authorities. Further, while the guidance aims to protect tax authorities, presumably there is no recourse for the taxpayers should the transfer price actually be too high once ex post outcomes are considered. We are concerned that the method described in the Discussion Draft consequently may lead to double taxation and an increase in tax disputes.

While we generally appreciate concise guidance we see the risk that the Discussion Draft leaves open plenty of room for interpretation. In

* BDI (Federation of German Industries) is the umbrella organization of German industry and industry-related service providers. It speaks on behalf of 36 sector associations and represents over 100,000 large, medium-sized and small enterprises with more than eight million employees. A third of German gross domestic product (GDP) is generated by German industry and industry-related service.

particular, there is no definition nor even narrowing of very important terms of Chapter VI of the OECD Transfer Pricing Guidelines, such as “satisfactory evidence”, “unforeseeable events” or “extraordinary”. We would also welcome further guidance on the MAP access that goes beyond the reference to BEPS Action Item 14. Last but not least, the examples given are not wide-ranging for different industries and the case at hand appears rather one-dimensional despite the choice of different scenarios.

Moreover, BDI is concerned with the proposal related to the burden of proof. It is our understanding from the Draft that taxpayers will need to demonstrate that all potential outcomes of the HTVI have been considered in the initial transactions. We believe that the taxpayer should only have to prove that the analysis was made in good faith, based on the information available at the time of the transaction and that the onus should be on the tax authorities to demonstrate that the taxpayer’s analyses were inaccurate and below the common standard of normal diligence / forecasts for such a transaction. Therefore, as long as sufficient contemporaneous documentation is provided during a tax audit, the burden of proof should remain on the tax administration.

Please do not hesitate to contact us if you have any questions.

Sincerely,

Berthold Welling Dr. Karoline Kampermann

Tax Treaties, Transfer Pricing and Financial Transactions Division
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75775 Paris Cedex 16
France

29 June 2017

Dear Sirs

**Discussion draft on 'Implementation Guidance on Hard-to-Value Intangibles'**

BDO welcomes the opportunity to comment on the OECD's Discussion Draft on the Implementation Guidance on Hard-to-Value Intangibles issued on 23 May 2017 ('the Discussion Draft'). These comments are provided on behalf of the BDO global network.

**Time frame**

Businesses operate more effectively where there is certainty. We note that a number of respondents to the original discussion draft requested a time frame being introduced for making adjustments. We would endorse that view and recommend specific guidance is given to tax administrations on time frames for seeking an adjustment.

In particular we believe it would be helpful if tax administrations were required to notify the taxpayer within a relatively short period that a transaction would be potentially within the scope of an *ex post* evidence review. In addition, there should either be an absolute cut-off date for tax administrations to start an enquiry, or alternatively, there should be strongly worded guidance to tax administrations saying that only in very exceptional circumstances should an *ex post* enquiry be started more than (say) six years after the end of the year in which the transaction took place.

If a less prescriptive timeframe is called for, another suggestion would be for tax authorities to be required to consider a deemed price adjustment clause, which can be found in third party agreements. If no specific price adjustment clause is included in a pricing agreement in relation to HTVIs, a reasonable monitoring period could be established based on agreements between third parties and applied to the transaction in order to establish a reasonable period during which a taxpayer should have to consider *ex post* evidence.

In order to avoid uncertainty for taxpayers, we would also suggest a mechanism to allow for faster review of transactions involving HTVIs by tax administrations, to avoid the requirement for unnecessary or prolonged tax provisions to be put in place. We would recommend potentially implementing a local process to enable tax authorities to identify transactions involving HTVIs at an early stage, and establish a timeframe during which the tax authority can assess this transaction, based on the availability of information required for such analysis. Potentially, this could be a two-sided requirement, whereby taxpayers are also obliged to specifically notify tax authorities of transfers of HTVI within a specific time frame, in addition to the description required under the master file information requirements.

**Evidencing the 'reasonableness of the taxpayer's assumptions'**

Example 1 and Example 2 both assume "the taxpayer cannot demonstrate that its original valuation properly took into account the possibility the sales would reach these levels, and cannot demonstrate that reaching that level of sales was due to an unforeseeable development." Further guidance would be helpful around the specific steps taxpayers should take to consider various scenarios of sales levels which are reasonably foreseeable at the time of the transaction, and suitable evidence which tax administrations should consider acceptable to demonstrate these considerations have been accounted for, e.g. documentation showing third party reports detailing expected industry trends, which have been used in conjunction with internally available information.

While it is not possible to provide an exhaustive list of unforeseeable developments, more examples of specific areas which would be considered an 'unforeseeable development' would also be helpful. In addition, some form of limitation or parameters should be set for tax administrations, in order to avoid unfettered entitlement to challenge transactions involving HTVI with the benefit of hindsight.

We note that the examples used focus on transactions in the pharmaceutical sector and royalty payments. It would be helpful if more detail was provided on alternative payment structures which could also lead to adjustments, so as to eliminate uncertainty about when a tax authority might expect a taxpayer to have considered an alternative method of payment.

**HTVI and the Mutual Agreement Procedure**

A key objective of the measures ought to be the avoidance of double taxation. We would therefore suggest that the guidance should include a stronger onus on the tax administrations to help ensure there is no double taxation as a result of any adjustment under these measures. Whilst the reference to the MAP in paragraphs 31 and the 32 of the discussion draft is helpful, we would like to see stronger encouragement for tax administrations raising an *ex post* enquiry to support the taxpayer in seeking symmetrical treatment for both sides of the transaction.

We would like to thank the OECD again for this opportunity to comment and would be happy to expand on our responses and contribute to further stages of this discussion draft if required.

For clarification of any aspect of our responses presented above please contact:


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Submitted by email: TransferPricing@oecd.org

**June 30, 2017**

## IMPLEMENTATION GUIDANCE ON HARD-TO-VALUE INTANGIBLES

Dear Mr. VanderWolk,

Business at OECD (BIAC) thanks the OECD for the opportunity to provide comments on its Discussion Draft on Implementation Guidance on Hard-to-Value Intangibles ("HTVI") issued 23 May 2017 (the "Discussion Draft").

This is a very complex subject and there is a significant risk of diverging interpretations. Therefore, BIAC welcomes the aim of the Discussion Draft to provide a common understanding for tax administrations with respect to adjustments resulting from the HTVI approach. However, we are concerned that the guidance is rather broad, but the examples not comprehensive enough. This means that it may be difficult for taxpayers to determine how they should approach a valuation exercise to ensure that they are deemed to have priced the transaction appropriately (i.e. to perform a valuation that protects them against adjustments in later periods). We offer some suggestions on how that certainty might be increased in ways that we believe will benefit both taxpayers and tax authorities.

Again, we thank you for the opportunity to comment, and stand ready to help further in any way that we can.

Sincerely,

Will Morris

Will Morris, Chair
BIAC Tax Committee

## GENERAL COMMENTS

1. HTVI is a highly complex subject, largely due to the subjectivity involved in trying to look into the future at the time of the transfer, allied with the difficulty of ignoring what actually happened after the transfer when judging the reasonableness of the original pricing decisions. Therefore, guidance intended to establish a common understanding amongst tax administrations and provide for consistent application of the HTVI approach must be sufficiently detailed to give both taxpayers and tax authorities confidence that adjustments are based on the pricing not having been made at arm's length at the time of the transfer, rather than as a result of hindsight (which our members fear would only lead to an adjustment where the adjustment favoured the tax authority).

2. The Discussion Draft primarily reiterates the broad concepts that were provided as part of the 2015 Final Report for Actions 8-10, "Aligning Transfer Pricing Outcomes with Value Creation" ("BEPS TP Report"). BIAC acknowledges that this may be an area where a number of tax administrations have limited experience, particularly in developing countries, but this fact should highlight the need for practical and unambiguous guidance over broad generalisations that may result in further uncertainty.

3. There is currently a very broad definition as to what constitutes a HTVI. While we appreciate that it would be nearly impossible to define precisely, we thought that additional helpful clarity may come from providing a list of features that indicate what is <u>not</u> considered a HTVI. There will be instances where an intangible clearly falls within the scope of the HTVI approach but often times it may be the case that intangibles are not isolated and perhaps merely contribute to one single piece of technology. It is unclear under the current definition whether the HTVI approach would be applicable in such instances.

4. BIAC acknowledges that the practical application of the exemptions listed in paragraph 6.193 of the BEPS TP Report, including the measurement of materiality and time periods contained in the current exemptions, will be reviewed by 2020 in light of further experience. This review will be welcome but we would urge the OECD to provide additional guidance in the interim related to these exemptions. This is a subject that will significantly affect many taxpayers in the immediate future so detailed guidance on the application of exemptions would be extremely useful.

5. The examples provided in the Discussion Draft are slightly limited and as a result do not provide as much clarity as they might into this complex subject. We recommend that the examples be expanded to provide tax administrations and taxpayers with factors that should be considered when drawing the critical line between whether there was or was not an appropriate weighting of the foreseeable developments or events relevant for the valuation at the time of the transaction.

6. Additionally, we believe the examples should not be limited to an analysis of HTVI solely within the pharmaceutical industry. This may have the unintended effect of drawing a line in the eyes of tax administrations that HTVI only exist in the pharmaceutical industry and may not reflect the more gradual development of intangibles in other industries.

7. BIAC would recommend including additional examples that cover multiple industries and results, including instances where no adjustment would be required (not due to the application of a specific exemption) and where multiple factors are considered and addressed to be within or without the scope of "anticipated" events. For instance, we would strongly support including an example which stresses the fundamental concept that ex-post evidence is to be used as a presumptive element to recalculate the ex-ante pricing and not as a straightforward element to make adjustments based on hindsight.

8. BIAC believes that guidance related to HTVI should also include insight into the relationship with other OECD transfer pricing guidance, specifically, profit splits of anticipated profits. For example, the recently released 2017 Discussion Draft on *Revised Guidance on Profit Splits* provides that the transactional profit split method may be the appropriate method where one party to the transaction does not share in the assumption of the economically significant risks which may result after entering into the transaction, and therefore a split of anticipated profits would be more appropriate. In such instances, guidance on HTVI should be very clear that ex-post results may (exceptionally) represent an indicator that anticipated profits were miscalculated, but this should not equate to ex-post results being used in a manner that by default will result in the application of the transactional profit split method based on actual profits versus anticipated profits.

## DETAILED COMMENTS

### Chapter 1: Introduction

Paragraph 5: BIAC agrees that information asymmetry between the information available to the taxpayer and the absence of information available to a tax administration is an area of concern to many tax authorities. However, BIAC would encourage additional guidance to incorporate an element of "proportionality" into any efforts to tackle this issue. It will be very important to avoid arriving at default presumptions that may have a disproportionate effect on smaller multinational enterprises ("MNEs"), MNEs whose product involves a very limited component of intangibles, or MNEs whose intangibles are marginal in relation to their overall business (i.e., intangibles that result incidentally but are not related to the core business of the MNE). This issue should also be addressed by the introduction of materiality thresholds such that the proportionality of efforts could be tied to the size of a specific transaction.

Paragraph 7: The OECD is correct in recognizing that the nature of the approach to HTVI will inevitably require consideration of timing issues and BIAC supports the application of audit practices by tax administrations in this regard. The Discussion Draft notes that tax administrations may face difficulty in evaluating the reliability of supporting information at the time of the transaction or shortly thereafter, but the reference to such analysis only being possible "some years after the transaction" must be balanced with the need for certainty on the part of taxpayers.

Whilst we appreciate that some intangibles may not realise their value for many years, this does not always result in a favourable result for taxpayers (and in fact increases the uncertainty of the valuation). BIAC strongly supports a recommendation for countries to incorporate statutes of limitation that will allow tax administrations reasonable time to collect the appropriate information on which to base a potential pricing adjustment and provide taxpayers with a sufficient amount of certainty. There must be a point in time where adjustments can no longer be made (particularly where a tax authority has had an opportunity to examine and assess the underlying documentation and assumptions) and that should be clear to all stakeholders.

Paragraph 12: The Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("Transfer Pricing Guidelines") provide in paragraph 6.192 that *"(…) In evaluating the ex ante pricing arrangements, the tax administration is entitled to use the ex post evidence about financial outcomes to inform the determination of the arm's length pricing arrangements, including any contingent pricing arrangements, that would have been made between independent enterprises at the time of the transaction, considering the guidance in paragraph 6.185."*

Paragraph 6.185 states that "*(…) If independent enterprises in comparable circumstances would have agreed on the inclusion of a mechanism to address high uncertainty in valuing the intangible (e.g. a price adjustment clause), the tax administration should be permitted to determine the pricing of a transaction involving an intangible or rights in an intangible on the basis of such mechanism. (…)".*

BIAC believes that this guidance addresses the requirement to assess what conditions would have been established ex-ante at arm's length to justify application of a different mechanism. However, it appears the language included in the Discussion Draft, which references paragraph 6.192 of the Transfer Pricing Guidelines creates a significant risk that the guidance in the Discussion Draft will be interpreted as providing tax authorities with the ability to choose a different pricing *mechanism* ex-post without reference to what unrelated parties would have done at the time of the transaction. BIAC would recommend that this language – as well as similar language contained in Paragraphs 13 and 28 of the Discussion Draft – be clarified to avoid tax administrations arriving at this incorrect interpretation.

**Chapter 2.1: Example 1 – Scenario B**

Paragraph 23: An exemption provided by item (iii) in paragraph 6.193 of the BEPS TP Report results in no adjustment being made by the tax administration in Scenario B of Example 1. There is an additional note that an adjustment under other sections of the Transfer Pricing Guidelines may be appropriate notwithstanding that the HTVI approach does not apply. BIAC believes that this sentence could be misinterpreted by tax authorities as a direction to seek other reasons on which to make an assessment. We would expect tax administrations to consider all appropriate adjustments so raising this point explicitly seems to go beyond the "neutrality" of spirit that an arm's length approach would require.

**Chapter 3: HTVI and the Mutual Agreement Procedure**

Paragraph 32: BIAC welcomes the access to the mutual agreement procedure ("MAP") for cases of double taxation arising from the application of the approach for HTVI. We would recommend additional guidance be provided as to how the approach for HTVI will fit within the MAP framework and specifically, the application of the presumptive evidence approach.

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OECD
Tax Treaties, Transfer Pricing and Financial Transactions Division, OECD/CTPA
Ref: Public Discussion Draft
Comments on Implementation Guidance on Hard to Value Intangibles

Reutte, 30 June, 2017

I appreciate and welcome the opportunity to present comments on the Draft published by the OECD dated 23rd May, 2017 regarding the implementation Guidance on Hard to Value Intangibles.

**1) Title**

In relation to the title, from my perspective and in order to avoid confusion among the tax administration and tax payers the title of the document should include the spirit of the same. Par. 3 of the daft mentions:

*"3. The BEPS TP Report mandates the development of guidance for tax administrations on the implementation of the approach for HTVI. This guidance is aimed at reaching a common understanding and practice among tax administrations on how to apply adjustments resulting from the application of the approach for HTVI. This guidance should improve consistency and reduce the risk of economic double taxation."*

Therefore, the title should mention that this Guidance is for tax administrations, since the content of the same has the purpose of reaching a common understanding among tax administrations on how to apply adjustments for HTVI cases.

**2) None profit shifting cases & Proportionality**

The guidance should encourage tax administrations to analyze the circumstances of the tax payer and its related party by using the information available in terms of tax rates and special legislation for the legal entities involved. This analysis can save the tax administration time and effort if it can be proved that profit shifting has not taken place. Usually, with the financial information of the legal entities involved in the transaction or tax return of the legal entities, the tax administration should be able to evaluate if a profit shifting took place or not. It does not make sense from a global perspective to spend resources in

a case were the tax payer had no possibility of shifting profit due to the tax rate/ local legislation of the legal entities involved.
I consider appropriate to mention the principle of proportionality through the document. Specifically in p. 13.

**3) Terminology**

From my perspective the guidance would create more certainty among tax administrations and tax payers if the use of vague terminology could be avoided. Wording like “certain conditions” and “appropriate circumstances” should be either further explained or specified. Even if the document is repetitive.

**4) Examples**

It would be appreciated if the OECD could work on more examples, not necessarily with the pharma industry but with the digital industry. Within the digital economy more challenges than the once presented in the examples are going to be a daily work for tax administrations. The traditional cases of the pharma industry are not the only cases of HTVI.

**5) Open topics**

The document is very limited. I was surprise to see that the document came to an end suddenly at page 7. There are a lot of open questions not only for tax administrations but I believe for anyone that had the opportunity to read the draft. For example, if the taxpayer agrees with a related party to analyze the result of the HTVI in a later point in time and if necessary adjust the remuneration for the transfer according to an ex post analysis, and this post analysis should take place after the audit.
How should tax administrations deal with procedural and timing issues if they will respect the statute of limitation. The document is not conclusive. It would be appropriate to include examples from the digital industry where much other factors can affect the results of a HTVI transfer, and in some cases the results might fluctuate without being consistent or permanent.

In general, I believe there could be more work to be done. Unfortunately the examples mentioned are limited to specific circumstances and specific industry under a traditional business models.

Brigitte Baumgartner

**Cajetan M. Fiedler**

To: Tax Treaties, Transfer Pricing and Financial Transactions Division, OECD/CTPA

Sent via email: TransferPricing@oecd.org

Zurich, 30 June 2017

**Re: Comments on the OECD's Public Discussion Draft "Implementation Guidance on Hard-to-Value Intangibles"**

Dear Sirs

I would like to thank you for the opportunity to provide comments on the public discussion draft "BEPS Action 8 – Implementation Guidance on Hard-to-Value Intangibles", published on 23 May 2017 (the "Draft Guidance"). The Draft Guidance is a further part of the work of the Committee on Fiscal Affairs and its subsidiary bodies in addressing base erosion and profit shifting. Appreciating and supporting this work, I hereby respectfully submit my observations and comments on the Draft Guidance.

## Background

With the revised paragraphs 6.186 to 6.195 of the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("OECD Guidelines"), the "Aligning Transfer Pricing Outcomes with Value Creation – Actions 8-10: Final Reports" contain new guidance on Hard-to-Value Intangibles ("HTVI") . The OECD defines HTVI as "intangibles or rights in intangibles for which, at the time of their transfer between associated enterprises, (i) no reliable comparables exist, and (ii) at the time the transaction was entered into, the projections of future cash flows or income expected to be derived from the transferred intangible are highly uncertain...."

Here, the OECD perceives an information asymmetry between taxpayers and tax administrations. This asymmetry may make it difficult for tax administrations to evaluate the pricing applied in the controlled transaction involving the HTVI. The information asymmetry includes especially the extent of information accounted for by the taxpayer in its pricing arrangements. Therefore, the tax administration may be in a weak position when scrutinizing if the applied pricing is in line with the arm's-length principle.

To mitigate this asymmetry, the new guidance proposes an approach to HTVI transactions involving the use of ex-post outcomes as "presumptive evidence" for the arm's-length characteristics of the pricing arrangement (the "Approach to HTVI". The OECD considers this approach to be in line with the arm's-length principle as well as distinguishable from situations in which ex-post results are directly used for tax assessments, without considering the availability of information at the time of entering into the transaction.

The Approach to HTVI is not to be applied, if the tax administration can confirm the reliability of the information used for this pricing arrangement. Specific situations in which it should not be used are listed in the new paragraph 6.193 of the OECD Guidelines. The Draft Guidance aims at improving the consistency in applying the Approach to HTVI by different tax administrations and thereby mitigating the risk of economic double taxation.

## Comments

In the following, I would like to comment on three aspects of the Draft Guidance: (i) the definition of HTVI, (ii) the examples given in the Draft Guidance, and (iii) the provision of information to the tax administrations.

Definition of HTVI

Many of the comments received on the draft version of the Approach to HTVI already pointed out that the definition of HTVI may be not sufficiently clear. Valuable intangibles that are relevant for transfer pricing considerations will typically be unique and likely lacking close comparables. Additionally, they will involve substantial uncertainties about their future profit potential. However, the Draft Guidance does not provide specific criteria based on which certain intangibles can be clearly excluded from the definition as an HTVI. This is especially the case, as the term “highly uncertain”, which is used to qualify the projected future cash flows/incomes, can be interpreted in a very broad manner.

Indirectly, the exemptions listed in new paragraph 6.193 of the OECD Guidelines contain a specification, as they exclude intangibles from the Approach to HTVI, if the deviation of the pricing based on the ex-post outcomes remains within a range of 20 percent from the ex-ante pricing used by the taxpayer. However, it would have been helpful, had the Draft Guidance provided rules and examples of how to exclude specific types of intangibles from the HTVI, without relying on ex-post data.

To illustrate this, it may be assumed that the commercial benefit from brand-related intangibles may be closely linked to a relatively small number of quantifiable factors, such as brand awareness or advertising expenditures over recent years. If this hypothesis applies, knowledge of the value of the factors would, within certain margins, allow a relatively reliable estimate of future commercial benefits, thus cash flows and income, from the intangible. This would contrast with an assumption that technological know-how (such as patents or trade secrets) may generally be prone to highly uncertain cash flow/income projections, due to influences such as the potential substitution effect of similar technologies that are under development.

It would require a substantial amount of research, to formulate and verify such hypotheses and make them useful for a future refined version of the Approach to HTVI. Some of this research may require costly and time-consuming original empirical work. Nevertheless, existing empirical studies may already contain valuable information that could be brought to use relatively fast and easy. The value of such insights would be that the area of application of the Approach to HTVI may be considerably narrowed down. This would not only relief taxpayers from taxation risk, but also allow tax administrations to focus their resources on more relevant areas.

Therefore, the OECD should consider to initiate and support deeper research in this direction and consider it for future guidance.

Examples given in the Draft Guidance

The examples of applying the Approach to HTVI given in paragraphs 14 through 30 of the Draft Guidance illustrate cases in which the actual results from the HTVI deviate from the projections due to earlier commercialization (thus, sales in years for which no sales were projected and the achievement of higher sales levels earlier than expected). While in the first example, this results in an adjustment of the remuneration for the transferred HTVI – as the year of the transfer is covered by the audit period – the second example describes a case in which the audit only covers years after the transfer, but not the transfer itself. In this example, the ex-post information is then used to assume an additional contingent payment after the transfer, resulting in an additional lump sum payment in one of the audited years, which is then brought to tax.

This indicates that instead of respecting the form of the transaction selected by the taxpayer, the tax administration may not only adjust transfer prices, but also modify the form of the transaction for tax purposes, if this is more convenient under the procedural framework provided for by laws and regulations. This bears the risk that tax administrations may use this example as a justification for circumventing the statute of limitations under their local tax laws. However, without strong reasons, such measures would harm legal certainty in the respective jurisdiction. Therefore, this example should either be removed or modified to avoid such potential effects.

Furthermore, while the given examples deal with ex-post results that deviate from the projected sales, the Draft Guidance is not providing comments or examples on potential reconsiderations of the applied assumptions on the risks connected with the HTVI, thus the discount rate used in the net present value calculation. If this means that under the Approach to HTVI the discount rates applied by the taxpayer are not subject to review based on ex-post outcomes, this should be made clear.

Provision of information to tax administrations

The main reason for developing the Approach to HTVI is the perceived potential information asymmetry between taxpayers and tax administrations. Consistent with this background, the first and second exemption from the Approach to HTVI in the new paragraph 6.193 of the OECD Guidelines deal with information provision to the tax administration and with advance pricing agreements between taxpayer and tax administration.

The Draft Guidance should build on this and propose more specific documentation requirements that may be introduced for transactions involving significant intangibles and recommendation for a more extensive use of possibilities for advance pricing agreements. Regarding documentation requirements, it may be helpful to propose the introduction of contemporaneous requirements that also involve the proactive filing of the respective report with the tax administration. This would enable the tax administration to examine such transactions early, based on the ex-ante information provided in the report, which may be a sufficient reason to grant an automatic exemption from the Approach to HTVI for the documented transaction after a relatively short period of time (and maybe without the condition that deviations of the actual results from the projections do not result in a revision of the compensation of more than 20 percent, as currently given in the third exemption provided for in the new paragraph 6.193).

Similarly, it may be appropriate to encourage tax administrations in expanding their resources for advance pricing agreements and taxpayers to engage in such procedures proactively. In my experience with the Japanese advance pricing agreement program, these means of solving possible conflict tend largely to generate agreeable outcomes for the involved tax administrations and the taxpayer. Therefore, they may deserve stronger advocacy than is currently contained in the Draft Guidance.

This concludes my comments.

I would also like to thank for the long timeframe given for providing comments on the Draft Guidance. In the past, the times provided have sometimes been considerably shorter, even down to only 14 days. While understanding that the whole BEPS project is under high time pressure, I hope that it will be possible to provide similarly adequate time for comments on future discussion drafts.

Yours sincerely,

Cajetan M. Fiedler

**OECD/G20 BEPS Action 8: Implementation Guidance on Hard-to Value Intangibles**
**Response by the Chartered Institute of Taxation**

## 1 Introduction

1.1 We refer to the Public Discussion Draft on Base Erosion and Profit Shifting (BEPS) Action 8 – Implementation Guidance on Hard-to-Value Intangibles published by the OECD on 23 May 2017.

1.2 The Chartered Institute of Taxation has consistently supported the BEPS project. We recognise that the BEPS measures are an important step to improving public trust in the international tax system. We agree that work done through Action 8 of the BEPS Action Plan in relation to developing special measures for transfers of hard-to-value intangibles (HTVI) was necessary to address the information asymmetry between taxpayers and some tax administrations. The pricing of intangibles is a very difficult area and may involve an element of subjectivity. In particular, we agree that in certain relatively rare circumstances it is appropriate for tax administrations to be able to consider *ex post* outcomes as presumptive evidence about the appropriateness of the *ex ante* pricing arrangements, subject to the taxpayers right to be able to rebut this presumptive evidence.

1.3 We welcome the implementation guidance presented by the discussion draft and support the aims of ensuring, so far as possible, that there is a common understanding and practice among tax administrations around the implementation of the BEPS actions and the application of the HTVI approach in particular. We also fully support the aims of achieving improved consistency and the reduction of the risk of double taxation.

1.4 It is important that this guidance is not seen in isolation, but as one part of the much wider framework the OECD transfer pricing guidelines make up. This implementation guidance should make it clear that the HTVI approach is designed to meet specific circumstances, and other solutions may be appropriate and should be applied in preference where this is not the case.

1.5 As an educational charity, our primary purpose is to promote education in taxation.

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One of the key aims of the CIOT is to work for a better, more efficient, tax system for all affected by it – taxpayers, their advisers and the authorities. Our comments and recommendations on tax issues are made solely in order to achieve this aim; we are a non-party-political organisation.

1.6 We would like to see greater certainty in the operation of international tax system, so businesses and individuals can plan ahead with confidence. In addition, we support a fair balance between the powers of tax administrations and the rights of taxpayers, together with responsive and competent tax administration. Our comments in regard to the implementation guidance are made in support of these principles.

## 2 Introduction in the Implementation Guidance

2.1 The introductory paragraphs of the implementation guidance helpfully summarise the principles which are set out in Section D.4 of the Revised Chapter VI of the Transfer Pricing Guidelines (the guidelines) in relation to hard-to-value-intangibles (HTVI).

2.2 The guidelines set out that under certain conditions, tax administrations are entitled to consider *ex post* outcomes as presumptive evidence about the appropriateness of the *ex ante* pricing arrangements. However, it is clear in the guidelines that the principle is that while the new information can be used to assess whether the arm's length price reached at the time of the transaction was correct and was reasonably arrived at, a tax administration is not permitted to reassess the value reached with the benefit of hindsight. It must be taken into account whether the information on which the *ex post* results are based could or should reasonably have been known and considered at the time the transaction was entered into (paragraph 6.188 of the guidelines).

2.3 We suggest that it would be helpful if the implementation guidance could reiterate (perhaps by expanding paragraph 6) that the use of presumptive evidence can be rebutted by taxpayers, and that the use of the HTVI approach explained in the examples should only arise in practice where there is an unreasonable lack of diligence on the part of the taxpayer in terms of providing the evidence set out in the exemptions in paragraph 6.193 of the guidelines. The implementation guidance could also emphasise that *ex post* evidence should only be used to assess the reliability of the information on which *ex ante* pricing has been based. As per paragraph 6.192 of the guidelines, '*Where the tax administration is able to confirm the reliability of the information on which* ex ante *pricing has been based, notwithstanding the approach described in this section, then adjustments … should not be* made.' In other words, just because a value turns out to be more than the agreed price as a result of events occurring after the event, this does not mean that the original valuation was incorrect.

2.4 As well as being clear that the guidance should only be applied where a transfer pricing adjustment is warranted, it is also important that it is only applied where no other approach would be more suitable. For example, we would argue that where a transfer of an intangible has taken place where the value is uncertain, but many of the DEMPE functions have continued to be carried out by the transferor, the better approach is to attribute a share of the ongoing intangible return to the transferor, rather than adjusting the transfer value at a later date. Including such guidance will help ensure that transfer pricing adjustments involving an *ex post* assessment of the value are unusual and not the norm.

2.5 It would be helpful if the implementation guidance could be expanded to also include guidance on the application of the exemptions set out in paragraph 6.193 of the guidelines, for example and, therefore, also deal with circumstances where the HTVI approach should not be used and no transfer pricing adjustment is warranted.

## 3 The Examples in the Implementation Guidance

3.1 We note that in paragraph 14, the implementation guidance says that the examples are not intended to be prescribing adjustments for particular industries. Nonetheless, we suggest that the fact that the examples only refer to the pharmaceutical industry is unhelpful and suggest that, either reference to any industry is removed, or one or more of the examples refer to a different industry.

3.2 As noted above, the examples are dealing with circumstances where a transfer pricing adjustment is warranted and it has been assumed (generally) that the taxpayer~~s~~ has not provided the necessary information so as to invoke the exemptions in paragraph 6.193 of the guidelines. However, we suggest that references to the taxpayer's right to rebut the use of *ex post* outcomes, and what it would be necessary for a taxpayer to demonstrate in order to do this, should be strengthened throughout the examples.

3.3 In Example 1, Scenario A it is stated '*The taxpayer cannot demonstrate that its original valuation properly took into account the possibility that sales would arise in earlier periods, and cannot demonstrate that such a development was unforeseeable*.' Similar wording is used in Example 2, Scenario B. It seems to us that this language suggests that in order to rebut the use of the presumptive evidence, the taxpayer would have to be able to prove a negative. To counteract this, we suggest that these statements should be qualified by '*and it was unreasonable to ignore such possibility and developments*'.

3.4 In Example 2, the taxpayer has not assumed sales above 1000 in any years, in particular later years. However, we suggest that consideration should be given to whether this assumption was based on an analysis that said there was a 25% chance of sales of 500, a 50% chance of sales of 1,000 and a 25% chance of sales of 1,500. In such circumstances, the taxpayer has considered the possibility of higher sales and, as such, its original valuation may be correct.

3.5 Example 2 discusses contingent payment arrangements which may or may not be common practice in the relevant business sector. We can envisage that a behavioural response to the guidelines and this implementation guidance (once finalised) may be that there is an increase in contingent payment arrangements, as these will enable taxpayers to better reflect *ex post* outcomes in the price for a transaction; particularly if it is considered that such an arrangement will be assumed to be standard practice by tax administrations and, therefore, taxed in any event. It is logical that this behaviour should, in turn, reduce the instances in which it is necessary or appropriate for tax administrations to use the HTVI approach. We suggest that this possible behavioural change and resulting reduction in necessary transfer pricing adjustments should be recognised in the implementation guidance as a successful outcome of BEPS Action 8.

3.6 In addition, however, it should also be explicitly recognised that if contingent payment arrangements are more commonly used, tax administrations should respect any downward adjustments built into such arrangements as a result of less favourable *ex post* outcomes as well as upward adjustments.

## 4 HTVI and the Mutual Agreement Procedure

4.1 We welcome the reiteration in the implementation guidance that it is important to permit resolution of cases of double taxation arising from the application of the approach for HTVI through access to the mutual agreement procedure. It is important that the guidelines and this implementation guidance does not inadvertently result in the introduction of asymmetry into the international tax system.

4.2 We would suggest that this is an area where, in due course, peer to peer review of countries' approaches in dealing with adjustments and corresponding adjustments (through MAP or a similar procedure) would be helpful. This would provide taxpayers with some transparency and help to build confidence in the administration of this complex and subjective area.

4.3 The implementation guidance also recognises the increased uncertainty for taxpayers as a result of the possibility of the HTVI approach. We welcome the comments encouraging tax administrations to identify transfers of HTVI as early as possible '*as a matter of good administrative practice*'.

4.4 In paragraph 10 reference is made to '*to act on presumptive evidence promptly*'. In line with our concerns around balancing this guidance on the implementation of the HTVI approach with considerations as to whether or not the approach is in fact necessary, discussed at paragraph 2 above, we suggest that this sentence could be amended to say something along the lines of:

*'… it remains important to identify transfers of HTVIs as early as possible and to <u>consider any presumptive evidence and whether or not this should lead to the application of the HTVI approach set out in the guidelines</u> promptly as a matter of good administrative practice …..'*

4.5 In terms of timing, we suggest that it would be helpful to have a statement that it would be appropriate for tax administrations to consider the level of difficulty and complexity in this area when applying their penalty regimes.

## 5 Acknowledgement of submission

5.1 We would be grateful if you could acknowledge safe receipt of this submission, and ensure that the Chartered Institute of Taxation is included in the List of Respondents when any outcome of the consultation is published.

## 6 The Chartered Institute of Taxation

6.1 The Chartered Institute of Taxation (CIOT) is the leading professional body in the United Kingdom concerned solely with taxation. The CIOT is an educational charity, promoting education and study of the administration and practice of taxation. One of our key aims is to work for a better, more efficient, tax system for all affected by it – taxpayers, their advisers and the authorities. The CIOT's work covers all aspects of taxation, including direct and indirect taxes and duties. Through our Low Incomes Tax Reform Group (LITRG), the CIOT has a particular focus on improving the tax system, including tax credits and benefits, for the unrepresented taxpayer.

The CIOT draws on our members' experience in private practice, commerce and industry, government and academia to improve tax administration and propose and explain how tax policy objectives can most effectively be achieved. We also link to, and draw on, similar leading professional tax bodies in other countries. The CIOT's comments and recommendations on tax issues are made in line with our charitable objectives: we are politically neutral in our work.

The CIOT's 18,000 members have the practising title of 'Chartered Tax Adviser' and the designatory letters 'CTA', to represent the leading tax qualification.

The Chartered Institute of Taxation
30 June 2017

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**Confederation of Swedish Enterprise - Comments on the OECD Public Discussion Draft entitled: "BEPS Action 8 Implementation Guidance on Hard-to-Value Intangibles)"**
**23 May - 30 June 2017**

The Confederation of Swedish Enterprise is Sweden's largest business federation representing 49 member organizations and 60 000 member companies in Sweden, equivalent to more than 90 per cent of the private sector.

The Confederation of Swedish Enterprise is pleased to provide comments on the OECD Discussion Draft entitled "BEPS Action 8 Implementation Guidance on Hard-to-Value Intangibles" 23 May – 30 June 2017 (hereinafter referred to as the Draft).

When valuation of an intangible or rights in an intangible at the time of the transaction is highly uncertain, it is of utmost importance that the integrity of the arm's length principle is maintained and that it is made clear that the question should be resolved, both by taxpayers and tax administrations, by reference to what independent enterprises would have done in comparable circumstances.

We believe that it is crucial that the guidance in relation to hard-to-value intangibles (including the examples in the Draft) is clear, well-balanced and predictable and should be targeted only on exceptional cases. Regrettable, that does not seem to be the case.

We are particularly concerned with example 2 (paragraphs 24-29) which significantly increases uncertainty for businesses, as it seems to suggest a possible extension of the statute of limitation at the discretion of a tax administration. We question e.g. the meaning of the term "*appropriate alternatives to making the adjustment in year 0*" (in paragraph 28). In addition, example 3 (paragraph 30), quite surprisingly, seems to suggest that the HTVI approach may in fact result in an increased risk of – unresolved – double taxation. Such an outcome is of course not acceptable. We therefore request that example 3 is deleted.

On behalf of the Confederation of Swedish Enterprise

June 30, 2017

Claes Hammarstedt
Senior Advisor at the Tax Policy Department

# Comment on: Implementation Guidance on Hard-to-Value Intangibles as of 23.05.2017

## 1 Summary

In practice, properly using ex post evidence may be more challenging than the current guidance implies. Given the complexity of the valuation issues

- two years of ex-post evidence are insufficient to reliably revise the overall valuation
- and to arrive at a profit adjustment.

The use of presumptive ex-post evidence should take into account the allocation of functions and risk between the entities involved. Such situation arises if the purchasing company creates additional value through process improvements achieved after acquisition of the intangible. Under arm's length conditions, the buyer may not automatically share the benefits through an adjusted purchase price.

The examples should be supplemented to clarify that presumptive ex-post evidence may also reveal that the initial valuation overstated the value of the underlying intangible.

If tax authorities employ the presumptive ex-post evidence as illustrated, transferring such intangibles for a single lump-sum payment leads to regular purchase price reviews and adjustment. In order to limit the risk of assessments and the associated administrative burden of mutual agreement procedures other pricing approaches should be considered. Ultimately transactional profit split procedures supplemented by means of advances pricing agreements may be appropriate to master the pricing challenges associated with hard-to-value intangibles.

## 2 Ex post evidence is used to cope with HTVI related valuation risk / information asymmetry

A transaction between controlled parties involves hard-to-value intangibles if the following conditions are met at the time of the transfer:

- reliable comparables do not exist;
- the future cash flows / economic benefit derived from the respective intangible and/or the underlying valuation assumptions are highly uncertain.[1]

As the future is unknown to the parties involved and the tax authorities the arm's length basis of the resulting value is not readily verifiable through a tax audit. Any attempt to verify the result requires an in-depth understanding of the valuation method chosen and the underlying assumptions. In particular, reviewing assumptions heavily relies on specialised knowledge and insights into the respective business segment[2].

In practice, taxpayers attributed any differences between the ex-ante and ex-post valuation

1 See [2], page 110, #6.189
2 See [2], page 109, #6.186

to events / conditions unforeseeable at the time of the transaction. Under the new approach, tax administrations infer from such discrepancies that the taxpayers valuation model did not properly reflect the uncertainties associated with the future exploitation of the respective intangible ("presumptive evidence")[3]. The rule – deemed in line with the arm's length principle – should enable tax administrations to determine whether or not a particular pricing arrangement chosen by the taxpayer is at arm's length and properly takes into account the foreseeable circumstances affecting the value of the respective intangible.[4]

In practice, properly using ex post evidence may be more challenging than the current guidance implies. The revised examples given below illustrate the challenges associated with the often indeterminate useful life of certain hard-to-value intangibles.

# 3 Review of Examples

## 3.1 Lump-sum payments for hard-to-value intangibles are not a preferred option

Given our limited ability to forecast the future, it is hardly possibly to develop a valuation procedure that is consistent with any actual outcome. In particular, if only two years of presumptive ex-post evidence are deemed sufficient to make assessments / adjustments different, more flexible pricing procedures should be used.

Eventually combinations of lump-sum payments, contingent payments and royalties may be more appropriate to cope with the valuation uncertainty. Combining lump-sum payments with contingent payments and/or royalties may be more appropriate to cope with the uncertainty inherent to the valuation of hard-to-value intangibles[5].

In particular, such combinations are more suitable to properly reflect the allocation of functions and risk between the entities involved. Eventually, some sort of transactional profit split may be useful to make sure that each entity receives remuneration commensurate with the functions performed and the risk assumed. Instead of an ex-post mutual agreement procedure advanced pricing procedures may be more appropriate to resolve such challenges with reasonable efforts.

## 3.2 Example 1

Company A, the developer and resident of country A, owns a patented pharmaceutical compound for which it completed phases I and II of the clinical trials. The patent is then sold to a foreign affiliate S, a resident of country S. Company S will conduct the phase III clinical trials, acquire approval and exploit the drug. The agreed lump sum price of 700,-- is the net present value of the expected cash flows. The valuation is based on the following assumptions:

- expected annual sales will not exceed 1.000;
- the discount rate is determined taking into account external data analysing the risk of failure for drugs in a similar category and stage of development;

3 See [2], pages 109/110, #6.188
4 See [1], page 2, #2
5 See [1], page 6, #28

• drug sales will start beginning year 6.[6]

Generally, patent protection expires after 20 years[7]. Since the patent is acquired earlier (e.g. 4 years before the right was transferred to company S), patent protection covers 10 years of sales. Please note that a drug's useful life does not necessarily expire with the patent protection. The product might still be sold but at a lower price and lower profits.

***Scenario A: limited ex-post evidence might be insufficient to justify an adjustment***

Five years after the transfer the tax administration audits company A for the years 0 – 2. As part of the audit, the tax administration obtained the following ex-post evidence associated with the above transfer of the intangible in year 0:

Company S completed the phase III trials earlier than initially expected and started selling the drug 3 years earlier extending the patent protected sales period to 13 years. The sales in years 3 and 4 are in line with the initial projections.

The taxpayer could not demonstrate that the initial valuation considered the opportunity of shorter phase III trials. The tax administration determined that the possibility of earlier sales should have been considered. Based on the adjusted valuation model, the net present value is 1.000 instead of 700. This leads to a profit adjustment of 300 for tax purposes.

Given the patent protected sales period of 10 – 13 years 2 years of ex-post evidence should be deemed insufficient to justify such an adjustment. After two years of business there is no evidence ruling out the risk that future sales are significantly lower than expected.

***Scenario A: earlier sales might be attributable to Company S process improvements***

The ex-post analysis should take into account the root cause of the earlier sales. Company S purchased the compound and conducted the phase III clinical trials. It specialises in these trials and continuously improves its processes in order to obtain approval as early as possible.

From the integrated group's point of view, such progress improves the integrated / consolidated net present value of a compound. This however, does not necessarily imply, that company S needs to share benefits stemming from own efforts with Company A through a higher purchase price in case of a first time innovation. In such situation it might be consistent with the arm's length principle to go without an adjustment to the initial sales prices.

## 3.3 Example 2

***Two years of deviating evidence may be insufficient to justify an adjustment***

Example 2 is similar to example 1 except that the tax administration reviews periods 3 – 5 in year 7. the audit does not constitute a follow-up audit. Although this would have been a more realistic scenario. The early sales findings discussed above are ignored. The audit reveals that sales in years 5 and 6 were significantly higher (1.500 instead of 1.000) than those projected.

Since the probability of higher sales was not considered initially and the higher sales are

6 See [1], page 5, #17 ff

7 European law provides a 5 year extension for particular drugs (supplementary protection certificates).

not attributable to unforeseeable events, the tax administration uses the presumptive evidence to adjust the initial valuation model. The resulting net present value is 1.600 and leads to an adjustment of 600 for tax purposes.[8]

Again, the crucial question whether two years of deviating ex-post evidence are sufficient to adjust the initial projection / forecast is implicitly answered in the affirmative. As already pointed out, this issue requires further clarification. Taxpayers may well be able to argue that since sales in the earlier years were in line with the projection the remaining future sales will be lower than initially expected.

***Company S may have implemented marketing and sales improvements***

Furthermore, Company S may have undertaken specific marketing efforts and/or may have established additional sales channels which have not been available when the purchase price was determined. In such situation – considering the arm's length principle – the extent to which Company S has to share such additional benefits with Company A is at least doubtful. Obviously, the entities functional and risk profile needs to be considered.

***Presumptive ex-post evidence leads to a reduction of the price***

The example is similar to example 2. However, the tax audit conducted in year 7 reveals that sales in years 5 and 6 were significantly lower than expected (500 instead of 1.000). Since the initial valuation did not provide for such low sales the intangible is re-valued on the basis of the presumptive ex-post evidence. The revised net present value is 500 – compared to the initially derived 700. As the adjustment of 200 is outside the 20% the threshold the purchase price has to be reduced for tax purposes.

# 4 References


[1] OECD, BEPS Action 8, Implementation Guidance on Hard-to-Value Intangibles, 23. May – 30. June 2017

[2] OECD / G20 Base Erosion and Profit Shifting Project, Aligning Transfer Pricing Outcomes with value creation, Actions 8-10: 2015 Final Reports


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8 See [1], page 6, #24 ff

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**Public Discussion Draft - BEPS Action 8 - Implementation guidance on hard-to-value intangibles**

Copenhagen Economics welcomes the opportunity to comment on the OECD's Discussion Draft on Implementation guidance on hard-to-value intangibles issued on 23 May 2017.

Copenhagen Economics supports the OECD's efforts to develop rules to prevent base erosion and profit shifting by engaging in transactions that involve hard-to-value intangibles.

Copenhagen Economics believes that additional clarifications on the proposed guidance and examples will help mitigate potential misinterpretations from both the taxpayer and the tax administration.

It is our opinion that clear and pragmatic guidance on hard-to-value intangibles would represent a further step in the direction of fostering transparency, certainty, and economic soundness.

We present our comments and feedback to the discussion draft below.

# 1 Background

Action 8 of the BEPS Action Plan mandated the development of transfer pricing rules or special measures for transfers of hard-to-value intangibles ("**HTVI**") aimed at preventing base erosion and profit shifting by moving intangibles among group members.

The outcome of this work is found in Section D.4 of the Revised Chapter VI of the Transfer Pricing Guidelines ("**Section D.4**"), contained in the 2015 Final Report for Actions 8-10, "Aligning Transfer Pricing Outcomes with Value Creation" ("**BEPS TP Report**") and now formally adopted as part of the Guidelines.

Section D.4 illustrates an approach that tax administrations can use to determine whether the pricing arrangements for the HTVI, as set by the taxpayers, are at arm's length, based on an appropriate weighting of foreseeable developments or events, or whether not. Under this approach, *ex post* evidences provide presumptive evidence as to the **existence of uncertainties at the time of the transaction**, whether the taxpayer appropriately considered reasonably foreseeable developments or events at the time of the transaction, and the reliability of the information used *ex ante* in determining the transfer price for the transfer of the HTVI.[1]

However, Section D.4 provides for four possible exemptions under which the approach will not apply. These exemptions include, among others: (i) the possibility for the taxpayer to rebut such presumptive evidences (by demonstrating the reliability of the information supporting the pricing methodology adopted, and evidence that any "significant difference" was unforeseeable or based on the probability of foreseeable outcomes occurring), and (ii) a 20% tolerance bandwidth, based on the discrepancy between the compensation determined at the time of the transaction using contemporaneous financial projections and the actual compensation for the HTVI transferred.[2]

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[1] See BEPS TP Report, para 6.188.
[2] Ibidem, para 6.193.

# 2 The Discussion Draft

The newly released public Discussion Draft "Implementation Guidance on HTVI" (the "**Discussion Draft**") aims at tackling the information asymmetry between the taxpayer and the tax administration.[3] In particular, the tax administration may find it difficult to objectively evaluate the taxpayers' pricing for the transfer of HTVI, given its relative lack of knowledge of each intangible.

Given this consideration, the Discussion Draft provides additional context and examples related to the appropriate use of *ex post* outcomes, and draws a scenario where the problem of properly assessing the pricing for HTVI is unique to the tax administrations,[4] without considering that pricing HTVI is uncertain for both, the taxpayer and the tax administration.

It is our opinion that the Discussion Draft poses a series of concerns related to both specific aspects and general principles of the OECD Transfer Pricing Guidelines, as elaborated in the following chapters. These concerns can be considered in three groups: The first considers how *ex post* outcomes relate to solving the potential problem of information asymmetry, the second considers the practical implementation of the 20% bandwidth exemption[5], and the third considers the impact of the HTVI approach on transfer pricing documentation requirements and other procedures.

# 3 HTVI, information asymmetry, and *ex post* outcomes

## 3.1 HTVI and information asymmetry

The term HTVI covers intangibles or rights in intangibles for which, at the time of their transfer between associated enterprises, (i) no reliable comparables exist, and (ii) **the 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, making it difficult to predict the level of ultimate success of the intangible at the time of the transfer.**

Once the nature of the HTVI, as properly described in Section D.4, and the ensuing difficulty in predicting the associated future income (or cash) flows are taken into ac-

[3] Compared to the tax administration, the taxpayer is likely to have more information that can be used to create a valuation report at the time of the transaction that appears comprehensive and robust. **The problem for tax administrations is that the valuation is extremely difficult to objectively evaluate** since it may be wholly based on the information provided by the taxpayer. Such information asymmetry restricts the ability of tax administrations to establish or verify developments or events that might be considered relevant for the pricing of a transaction involving the transfer of intangibles or rights in intangibles, as well as the extent to which the occurrence of such developments or events, or the direction they take, might have been foreseen or reasonably foreseeable at the time the transaction was entered into. See Discussion Draft, para 5 (Emphasis added).

[4] However, it should be kept in mind that **it may be difficult for tax administrations to perform a risk assessment at the time of the transaction** or even shortly thereafter, to evaluate the reliability of the information on which pricing has been based, or to consider whether the transfer is priced at arm's length. See Discussion Draft, para 7 (Emphasis added).

[5] As defined in Section D.4, para 6.193.

count, it is clear that the difficulty in assessing the price of HTVI affects both the tax payer and the tax administration.

The *ex ante* actual lack of information results in a distribution of potential outcomes, and is decisive for the recorded transfer price. This lack of precise information is what makes the valuation uncertain and difficult. The difficulty may be amplified for the tax administration, who may lack business-specific knowledge relative to the tax payer, resulting in information asymmetry. However, as of the valuation date neither tax payer nor tax administration possess knowledge about actual distribution of outcomes[6].

In other words, information asymmetry may exist between the taxpayer and the tax administration (such that the taxpayer has better information surrounding its own businesses relative to the tax authority), but the main issue in assessing the pricing of HTVI is first and foremost that the valuation of HTVI is *always* highly uncertain for both parties.

### 3.2 *Ex post* outcomes to minimize information asymmetry

Given this inherent uncertainty and the Discussion Draft's assumption of information asymmetry that favours the tax payer, the question we ought to ask is: Does allowing the tax authority to use *ex post* outcomes to evaluate the HTVI transfer price (and its underlying assumptions) as submitted by the tax payer solve (or, at least, minimize) the problem of information asymmetry?

Indeed, on the basis the arguments reported in the Discussion Draft, a significant and incurable information asymmetry will exist between the taxpayer and the tax administration regarding the assumptions each party may take into account in the pricing of HTVI. The Discussion Draft confirms that the tax authority can use *ex post* outcomes for its evaluation, even though this information is not (and cannot be) available to the taxpayer at the time of the transaction, and sees giving room to *ex post* assessments as the only way to address the hard-to-value nature of such intangibles.[7] The implication of this is that the tax authority removes all uncertainty surrounding the assumptions used by the taxpayer in valuing the intangible.

This does not *minimize* the information asymmetry between the taxpayer and the tax authority – it changes the direction of the asymmetry in favour of the tax authority, and, in fact, increases the asymmetry, as the taxpayer *cannot* have access to the information with which the tax authority will evaluate the arm's length nature of the transfer price. Therefore, the use of *ex post* data to the valuation does not reflect the nature and character of a HTVI and may not be in line with the arm's length principle.

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[6] It is not unusual that the evaluation of intangibles and businesses, performed with different methodologies, leads to a range of potential results on the basis of foreseeable trends and reasonable assumptions, often tested by means of sensitivity analyses. At the time of the transaction, the pricing for the transfer of HTVI represents only one potential outcome within the distribution of values resulting from the methodologies applied.

[7] **Such analysis may only be possible some years after the transaction**. Under the HTVI approach, the tax administration may, in appropriate circumstances, use *ex post* outcomes to consider the appropriateness of the projections and probability weightings taken into account in the valuation at the time of the transaction. See Discussion Draft, para 7 (Emphasis added).

In our view, the information asymmetry between the taxpayer and the tax administration at the time of the transaction is not cured by looking at and incorporating *ex post* data into the valuation. It is instead exacerbated, albeit in favour of the tax authority. Given the OECD's stated goal of addressing the information asymmetry between the parties to ensure the tax authority can evaluate HTVI pricing, further guidance on this topic is needed.

Irrespective of the direction of information asymmetry between the parties, there are several areas where we believe additional clarification is required to enable taxpayers and tax authorities to efficiently manage transfer pricing challenges for HTVI. These are addressed below, as presented in the Discussion Draft.

# 4 The effects of the 20% bandwidth exemption

As indicated above, one exemption provided for in Section D.4 relates to the magnitude of the discrepancy between the *ex ante* projected outcome (made at the time the transaction took place) and the *ex post* outcome: When the difference between the financial projections and actual outcomes falls in the +/- 20% range of the compensation determined at the time of the transaction, the HTVI approach does not apply.[8]

In our view, there are at least three issues related to this exemption which would benefit from additional guidance from the OECD.

**The bandwidth is arbitrary**

First, and most importantly, the 20% bandwidth is arbitrary. No explanation for the use of 20% as a guideline is provided,[9] and further, the Discussion Draft does not address a) the impact of a change in the bandwidth, b) industry specific characteristics and/or c) the nature of the intangible at stake.

There is no discussion of the selection of 20% or of the impact of a change to the benchmark, yet the implications for the taxpayers could be significant should a different benchmark be selected. The Discussion Draft notes that the OECD will review this threshold, and may adjust the benchmark by 2020, but in our opinion this requires additional clarity at present.

The arbitrary nature of the 20% bandwidth highlights the importance of industry- and intangible-specific information to the pricing of HTVI. The historical results provide, indeed, examples of industries where intangibles have proven to be extremely volatile (in terms of both success/failure rates and related values) where compared to the *ex ante* valuations.

Moreover, different categories of intangibles (e.g. formulae, patents, trademarks, licenses, etc.) may influence relevant discrepancies between expected and actual returns (e.g. blockbuster drug).

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[8] See Section D.4, para 6.193 iii).
[9] There is no explanation for the use of 20% in either Section D.4 or the Discussion Draft.

It is our opinion that further guidance is needed in order to substantiate, justify, and differentiate the 20% bandwidth exemption, taking into account the industry specific and the intangible characteristics.

**The bandwidth does not protect the tax payer from *ex post* assessments**

Second, it is unclear whether tax authority can effectively ignore the 20% benchmark exemption in certain circumstances. Scenario B of Example 1 reported in the Discussion Draft concludes that **an adjustment** under other sections of these Guidelines **may be appropriate** although the potential adjustment due to differences between the *ex ante* projections and *ex post* results falls within the 20% threshold.[10]

In our opinion, the cited example of the Discussion Draft creates an apparent inconsistency with the original guidance on the safe harbor nature of the 20% bandwidth contained in Section D.4, and therefore, it is our opinion that further clarification on this point is needed.

**The bandwidth might cause a shift of the burden of proof**

Third, based on the current guidance on HTVI, tax administrations are entitled to consider *ex post* outcomes as presumptive evidence about the appropriateness of the *ex ante* pricing arrangements under certain conditions.[11]

This means that, excluding the case of transfers of HTVI covered by a bilateral or multilateral advance pricing arrangement,[12] any time the difference between the *ex ante* financial projections and the *ex post* outcomes determines an under/overvalue for the transfer of the HTVI outside the 20% bandwidth, this might cause a shift of the burden of proof on the tax payer.
Moreover, considering the subjective and discretionary nature of the exemption i) under Section D.4, Para 6.193 related to e.g. foreseeability and appropriateness,[13] adjust-

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[10] The tax administration uses the presumptive evidence based on the *ex post* outcome to determine that the possibility of earlier sales should have been taken into account in the valuation. The taxpayer's original valuation is revised to include earlier sales resulting in a revised net present value of the drug in Year 0 of 800 instead of 700. Therefore, assume for the purposes of the example that the arm's length price anticipated in Year 0 should have been 800. [...]
In accordance with the approach to HTVI, the tax administration is entitled to make an adjustment to assess the additional profits of 100 in Year 0. However, in this example, **the exemption provided by item (iii) in paragraph 6.193 applies since the adjustment to the compensation for the transfer is within 20% of the compensation determined at the time of the transaction. Notwithstanding that the HTVI approach does not apply, an adjustment under other sections of these Guidelines may be appropriate**. (See Discussion Draft, para 22-23).

[11] **Where, for example, the actual income or cash flows are significantly higher than the anticipated income or cash flows on which the pricing was based, then there is presumptive evidence that the projected income or cash flows used in the original valuation should have been higher**, and that the probability-weighting of such an outcome requires scrutiny, taking into account what was known and could have been anticipated at the time of entering into the transaction involving the HTVI. See Discussion Draft, para 6 (Emphasis added).

[12] See exemption ii) under Section D.4, para 6.193.

[13] The taxpayer provides: 1. Details of the *ex ante* projections used at the time of the transfer to determine the pricing arrangements, including how risks were accounted for in calculations to determine the price (e.g. probability-weighted), and **the appropriateness of its consideration of reasonably foreseeable events and other risks, and the probability of occurrence**; and, 2. Reliable evidence that **any significant difference** between the financial projections and actual outcomes **is due to: a) unforeseeable developments or events occurring after the determination of the price** that could not have been anticipated by the associated enterprises at the time of the transaction; or b) the playing out of probability of occurrence of foreseeable outcomes, and that these probabilities were not significantly overestimated or underestimated at the time of the transaction (emphasis added).

ments in the pricing of the HTVI may be at the full discretion of the tax authority.[14] In our view, a further clarification on this point is needed.

# 5 The impact of the HTVI approach on transfer pricing documentation requirements and other procedures

In the light of the high uncertainty surrounding the pricing of HTVI and the potential assessments made by tax administrations, as described in the previous sections, a further element that requires clarifications is the potential impact of the HTVI approach on the transfer pricing documentation.

## 5.1 Timing issues

Both Section D.4 and the Discussion Draft address timing as a potential challenge related to the use of *ex post* outcomes. In particular, the Discussion Draft notes that *ex post* outcomes may not even be available until years after the transaction and/or the audit window.[15] However, as time passes, information which was once a projection can be measured, and will ultimately determine the *ex post* outcome. The Discussion Draft does not provide guidance as to how the availability (or lack thereof) of *ex post* outcomes impact the use of actual information at the time of the audit, and creates a period of uncertainty for the taxpayer. For example, if a HTVI transaction, realized in year 1 (comprising net present value of a multi-year cash flow) is audited by a tax authority during year 3, and the outcome has not yet occurred, **will actual information as of the time of the audit be considered by the tax authority**?

Section D.4 and the Discussion Draft make no mention of how the difference in value between the *ex ante* valuation and the valuation completed at the time of the audit (or the *ex post* outcome, which may or may not be available at the time of the audit) will actually be calculated[16].

Moreover, the Discussion Draft makes no reference on how to account for bidirectional differences between the *ex ante* projections and actual results, in different years of the valuation plan. For example, consider:

- A transfer of a HTVI made in year 1, for c.a. Euro 3,000, based on the assumption of constant sales from year 5 to year 10 equal to 1,000 per year.
- In year 7 the tax administration audits the HTVI transfer and recognizes significantly higher sales in year 5 and 6, equal to 1,900 per year. Given the discrepancy, the tax administration determines the *ex post* value for the HTVI, equal to c.a. Euro

[14] In circumstances **where the taxpayer can satisfactorily demonstrate what was foreseeable at the time of the transaction** and reflected in the pricing assumptions, and that the developments leading to the difference between projections and outcomes arose from unforeseeable events, tax administrations will not be entitled to make adjustments to the *ex ante* pricing arrangements based on *ex post* outcomes. See Section D.4, para 6.194 (Emphasis added).

[15] See Discussion Draft, para 7-11.

[16] For example, consider a pharmaceutical company who expects to release a drug in 4 years (t4). In the event that the drug goes to market 1 year early (t3), the cash flow for that year (t3) will be significantly higher such that the *ex post* revenue is more than 20% greater than anticipated *ex ante*. However, if the company's other expectations (e.g. market price, market size, duration) are accurate, the total cash flow across several years may be within the 20% bandwidth, which will only be clear at some point in the future. Depending on the date of the tax authority audit, this information may or may not be available, but if it is, how will the tax authority define the *ex ante* value relative to the *ex post* value?

4,000, and concludes the audit with an assessment for the transfer of the HTVI, equal to Euro 1,000 (see Table 1, below).

## Table 1 – Example

| | | | | | | |
|---|---|---|---|---|---|---|
| WACC | 10% | 10% | 10% | 10% | 10% | 10% |
| Year | 5 | 6 | 7 | 8 | 9 | 10 |
| Sales | 1.000 | 1.000 | 1.000 | 1.000 | 1.000 | 1.000 |
| Present value | 621 | 564 | 513 | 467 | 424 | 386 |
| **HTVI Pricing** | | | | | | **2.975** |
| | | | **Tax Audit** | | | |
| WACC | 10% | 10% | 10% | 10% | 10% | 10% |
| Year | 5 | 6 | 7 | 8 | 9 | 10 |
| Sales | 1.900 | 1.900 | 1.000 | 1.000 | 1.000 | 1.000 |
| Present value | 1.180 | 1.073 | 513 | 467 | 424 | 386 |
| **HTVI Audited price** | | | | | | **4.042** |

Consider now that, after the tax assessment, the sales related to the HTVI suddenly decrease to Euro 500 from year 7 to year 10. Although the high volatility of sales related to the HTVI leads to an *ex post* value of the HTVI (determined at the end of the six-year plan) very close to the pricing determined in year 1, no further guidance is provided for in order to take into account the developments following the tax assessment (see Table 2 below).

## Table 2 – Example

| | | | | | | |
|---|---|---|---|---|---|---|
| WACC | 10% | 10% | 10% | 10% | 10% | 10% |
| Year | 5 | 6 | 7 | 8 | 9 | 10 |
| Sales | 1.900 | 1.900 | 500 | 500 | 500 | 500 |
| Present value | 1.180 | 1.073 | 257 | 233 | 212 | 193 |
| **HTVI Ex Post Value** | | | | | | **3.147** |
| HTVI Pricing | | | | | | 2.975 |
| Delta | | | | | | 172 |
| **Delta %** | | | | | | **6%** |

As presented in the example, the initial pricing made by the taxpayer on the basis of valuation techniques accounts for uncertainties and different projected outcomes. By making an assessment on the actual outcome (in the example, on an intermediate outcome), the tax authority disregards any assumptions of the taxpayer about the (at the time of the initial pricing, *future*) uncertainties and projected outcomes.
In our view, a further guidance in this regard is needed.

### 5.2 Documentation requirements and other procedures

The potential use of presumptive evidences of *ex post* results by tax administrations in assessing and adjusting the intercompany price for the transfer of HTVI will increase uncertainty and risk for the taxpayer concerning (i) the correct filing of the tax return and (ii) the transfer pricing documentation requirements.

In addition to allowing for the use of *ex post* outcomes, the Discussion Draft highlights the ability of the tax administration to make adjustments not only to the value of the transaction, but to the structure of the transaction.[17] In our opinion, it is inappropriate to allow the tax authority to use *ex post* outcomes to make adjustments to the pricing structure without providing explicit guidance on what documentation is required to prove the reasonable nature of the valuation *ex ante*. This is particularly relevant where the pricing structure is defined as part of a license agreement. Two parties may have significantly different expectations about the future, and yet find a way to agree on the terms a license including running royalty payments, fixed lump-sum payments (e.g. milestone payments) or other payment terms (e.g. caps and floors).

Moreover, in normal business dealings, the pricing of a HTVI is often made by means of valuation approaches, which specifically take future uncertainties into account, while the use of *ex post* adjustments (i.e. price adjustment clauses) may be limited.

To allow hindsight to alter those terms would be inconsistent with business reality, and would make it increasingly difficult for companies to prove the “reasonableness” of their own transactions.[18]

Based on the current Discussion Draft, it is unclear whether tax decisions or documentation requirements may require activities other than what is conducted in the normal course of business. As a result, it is uncertain whether these requirements and resulting decisions will be inconsistent with other business practices, and in turn, whether these inconsistencies will impact other business areas, such as e.g. licensing practices, IP disputes. It is our opinion that a clarification on this point is needed in order to prevent the distortion of future business decisions, as well as the impact of other proceedings (e.g. IP disputes), which base their information on respective company data.

## 6 Final suggestions

It is our opinion that, in order to cope with the information asymmetry between the taxpayer and tax authority, the future guidance on HTVI should focus on clarifying and

[17] “Tax administrations may make appropriate adjustments, including adjustments that reflect an alternative pricing structure that is different from the structure adopted by the taxpayer (for example, milestone payments, running royalties with or without adjustable elements, price adjustment clauses, or a combination of these characteristics.) See Paragraph 6.192.” Discussion Draft, para 12.

[18] Imagine the hypothetical arms-length negotiation between two parties, in which Company A agrees to license the use of its patents to Company B, who makes and sells widgets, for ten years. If each party has a different expectation of future widget sales (which may also be unknown to the other party), the two may still agree on a lump sum (fixed fee) license payment. If in year 2, Company A transfers its license agreement, it will consider its own expected valuation. However, *ex post*, it will become possible to determine the net effective royalty rate per widget. If Company A turned out to be wrong in its projected widget sales, and the tax authority were to use the *ex post* data to evaluate Company A’s pricing, it could be very difficult to prove reasonableness of projections, which are by nature, uncertain.

improving documentation requirements, including identifying defined sharing points with the tax administration.

In particular, the future guidance on HTVI should rather discuss:

1. A notification requirement in order to allow the tax administration to timely assess the assumptions made by the taxpayer in pricing the HTVI;
2. An appropriate procedure for documenting the assumptions underlying the *ex ante* pricing of the HTVI, opposed to judging the pricing *ex post* with hindsight.

This could help the taxpayer to satisfactorily demonstrate the foreseeable developments taken into account at the time of the transaction and reflected in the pricing assumptions, and help the tax administration to verify these assumptions.

In addition, it is our opinion that a revision of the 20% bandwidth exemption is needed in order to take into account the industry specific characteristics and the nature of the HTVI.

Finally, it is our opinion that future guidance on HTVI should also consider the impact of the HTVI approach on transfer pricing documentation requirements.
We very much hope that you find our comments useful, and we look forward to working with you on these important issues over the next months.

For clarification of any aspect of our responses presented above please contact:


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Dear Jeff

**BEPS Action 8: Implementation Guidance on Hard-to-Value Intangibles**

Thank you for the opportunity to comment on *BEPS Action 8: Implementation Guidance on Hard-to-Value Intangibles* published on 23 May 2017 (the 'Discussion Draft'). These comments are written from the perspective of the UK.

It is important that guidance in relation to the treatment of hard-to-value intangibles is as clear and unambiguous as possible. Any new guidance should, as a fundamental objective, seek to minimise the number of disputes and disagreements that will arise. The provision of more extensive guidance and more detailed examples would decrease the likelihood of disputes that will require time and resources from businesses and tax authorities to resolve, and may lead to double taxation where resolution is not available.

In addition, it is likely that some businesses will consider using price adjustment clauses in contracts between related parties in relation to future transactions involving hard-to-value intangibles to reflect the principles set out by the OECD (for example, these may take the form of contingent pricing arrangements). It is essential and proportionate that tax relief is available where amounts are paid or repaid under these contractual arrangements where they are in line with the hard-to-value intangibles approach, such that there is symmetry of treatment. Guidance and examples showing how this would work would be welcome. In particular, allowing such symmetrical tax relief on payments or repayments without the need for recourse to MAP in all cases would be helpful as it would free up the MAP process for cases of genuine dispute. It would remain open to tax authorities, of course, to examine the payments or repayments under audit which may lead to further adjustments and the need for MAP.

Where the hard-to-value intangibles approach applies, the principle that tax authorities can consider *ex post* outcomes as presumptive evidence about the appropriateness of the *ex ante* pricing arrangements is balanced by the principle that the probability of achieving such income or cash flows at the time of the transfer of the hard-to-value intangibles should be taken into account. However, the current examples do not provide any guidance as to how this should be balanced. It is important that there are examples of the circumstances in which it would be reasonable to conclude that is appropriate to rebut presumptive evidence, for example on the basis of the playing out of probabilities that were taken into account at the time of the transaction. Whilst the guidance says that it is *presumptive* evidence, a difference between *ex post* profitability and *ex ante* expectations is not *conclusive* evidence that an adjustment is required. The burden of proof should require a business to demonstrate that the pricing reflects an approach that would have been

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taken by third parties (acting in a reasonable manner) at the time of the transaction, taking into account all anticipated events.

Additional examples and guidance would be welcomed in a number of areas of complexity, including for example in respect of multiple year analysis where there is variability of outcomes in different years.

Further comments on the Discussion Draft are set out in the attached Appendix.

If you would like to discuss any of the points raised in this letter, please do not hesitate to contact John Henshall (jhenshall@deloitte.co.uk), Alison Lobb (alobb@deloitte.co.uk)or me (bdodwell@delotite.co.uk). We would be happy to speak on this topic at the public consultation meeting to be held in due course.

Yours sincerely

Bill Dodwell

**WJI Dodwell**
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**Appendix**

**1. Guidance on ex-post and ex-ante information**

The revised guidance should be clear that there is no departure from the application of the arm's length principle in relation to the pricing of hard-to-value intangibles. Instead, the guidance should clarify its application. The Discussion Draft sets out principles which reflect the balance between the concerns of tax authorities related to the potential for asymmetry of information (i.e. between the information that tax authorities have and that which the business has), and the ability to demonstrate that the presumptive evidence of outcomes should be rebutted on the basis of the evidence that foreseeable events were identified and assigned appropriate probabilities at the time of the transaction. The use of *ex post* outcomes should be restricted to appropriate circumstances and then only used to 'consider the appropriateness of the projections and probability weightings taken into account in the valuation at the time of the transaction'. A difference between *ex post* profitability and *ex ante* expectations is an indication that the valuation may require audit, not conclusive evidence that an adjustment is required.

A rigorous transfer pricing analysis at the time of the transaction should take into account reasonably foreseeable developments or events at the time of the transaction. Decisions in commercial court disputes have supported the view that valuation should be made on the basis of conditions and information available before the transaction takes place.

*Ex post* evidence should not be used without considering whether the information on which the *ex post* results are based could or should reasonably have been considered by the related parties at the time the transaction was entered into. Whilst there is a place for weighting of probabilities related to likely outcomes, a number of commercial court decisions (see, for example, *Force India Formula One Team Limited v Aerolab* SRL ([2012] EWHC 616)) indicate the types of factors that should be considered and, importantly, those that should not.

Businesses can rebut the presumptive evidence of outcomes by demonstrating that any significant differences between the financial projections and actual outcomes were either due to unforeseeable events or due to 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. Para 6.192 of the *OECD Transfer Pricing Guidelines* very clearly states that 'Where the tax administration is able to confirm the reliability of the information on which *ex ante* pricing has been based … then adjustments based on *ex post* profit levels should not be made'.

The examples currently focus on fact patterns where a business is unable to demonstrate that a development was unforeseeable. It is not possible to prove non-existence in this way and the burden of proof on businesses should only be limited to demonstrating the reasonableness of their approach. It is essential that examples are included that consider the business's approach to weighting probabilities of foreseeable outcomes (whilst validly excluding unforeseeable outcomes) which come to the conclusion that ex-post information is rebutted.

*Probability weighting*

Businesses are required to consider probability weightings in their valuation. For example, a business may calculate a valuation based on an expected level of sales of 240, based on the following probabilities: 20%- 100, 50%- 200, 30%- 400. To the extent that the business can demonstrate that the probabilities assigned to each level of sales were reasonable based on the information at the time of the transaction, no adjustment should be required if the *ex post* results reflected sales of 400 as this outcome was considered and evaluated at the time of the transaction.

In cases where a tax authority considers that there has been an understatement of the probability of an outcome, a reduction is mathematically required in respect of the probability of other potential outcomes (i.e that the total of probabilities continue to sum to 100%). To the extent an adjustment is required to the valuation, this should reflect the net result of the adjusted outcomes.

Considering the previous example of probabilities, a tax authority may consider that the probability assigned to sales of 400 should have been 50%. A further amendment is required so that (for example) the probability assigned to sales of 200 is reduced to 30%. On this basis, the expected level of sales would be calculated as 280. (An adjustment will be required if the difference between the financial projections and actual outcomes change the valuation by more than 20%, which will depend on all factors including sales but may not be the case in this example).

*Price adjustment clauses*

Price adjustment or contingent payment clauses in contracts are used in some third party situations. There are however many transactions where no such clause is included and the appropriateness of adoption in an intra-group context should reflect this. Where there is evidence of third party transactions of a similar nature including price adjustment clauses or contingent payment arrangements it is reasonable for businesses to adopt similar in their inter-company contracts.

The passage of time reduces the likelihood of a future event being accurately predicted. Where price adjustment clauses are found in contractual terms between third parties, these will in almost all cases include a time limit of just a few years during which adjustments are to be made. The Discussion Draft should emphasise the need for contingent pricing arrangements to reflect those that would have been made between third parties.

A price adjustment clause between third parties would generally allow for both an upward and a downward adjustment and it is essential that in such a situation the arm's length principle is applied to intra-group transactions in a way that affords the same symmetry of treatment to group companies. Both the upward and downward price adjustments should be respected for tax purposes by tax authorities. The contractual basis for any such approach under the arm's length principle should allow for deductions on this basis.

In particular, such symmetry of treatment of contractual price adjustment clauses or contingent payment mechanisms should be available without requiring a mutual agreement procedure claim. It will remain the prerogative of tax authorities to audit the pricing and operation of the adjustment clauses or contingent prices (and if an adjustment is made then there will be a need for mutual agreement procedures).

*Multi-year analysis*

The Discussion Draft does not currently provide guidance on the application of the approach over multiple years.

For example, a hard-to-value intangible is transferred between connected parties in Year 0. The financial outcome is within the acceptable range for Year 1 and Year 2. However, in Year 3, there was a significant increase in sales during that period. Sales returned to anticipated levels during Year 4.

To what extent would an adjustment be required in Year 3? Is any adjustment related to Year 3 only or is the adjustment cumulative over Years 1 -3? What happens in Year 4?

*Transition and timing*

No guidance is included in the Discussion Draft in respect of when the new rules become effective. For example, do the new rules apply only to transactions or taxable periods commencing after a certain date? Should the hard-to-value intangibles approach be applied in respect of transactions undertaken in prior periods, but for which the financial results arise in open tax years?

## 2. Examples

In order for the Discussion Draft to promote common understanding and practice in, further examples are needed which cover the widest possible range of fact patterns, such as:

- Scenarios where there are significant cash flows fluctuations;
- The analysis of *ex post* outcomes indicates that a lower valuation is required;
- Portfolios of intangibles;
- Examples to illustrate complexities in the practical application of the exemptions, particularly in respect of the measurement of materiality and time periods; and
- Examples from a range of industries.

Clear examples are needed to demonstrate when and how *ex post* information should be used, including cases where a transfer pricing adjustment will not be required:

- Fact patterns where the use of *ex post* outcomes is not appropriate;
- Examples which illustrate how businesses can demonstrate that the valuations undertaken at the time of the transaction properly took into account future developments;
- Examples of when the *ex post* information is considered hindsight and should not therefore be taken into account;
- Examples of what is considered to be satisfactory evidence of unforeseeable or extraordinary outcomes would be helpful. As a minimum, we would expect this to include macroeconomic developments such as recessions and government actions as well as natural disasters and other *forces majeure*. The commercial world gives rise to innumerable examples where third party transactions have not led to the results expected for a wide variety of reasons; and
- Examples of what is considered to be satisfactory evidence that the probability of occurrence of foreseeable outcomes were not significantly overestimated or underestimated at the time of the transaction.

*Example 3*

In our experience, it is highly unusual for a royalty payment to be paid on a percentage of anticipated sales. It is usual to calculate a value and the associated royalty based on anticipated sales, but the royalty rate is then applied to the actual sales made. In such a circumstance, an adjustment may not be required as the value of the royalty paid would automatically increase in line with the level of sales.

## 3. Hard-to-Value Intangibles and the Mutual Agreement Procedure

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 mutual agreement procedures.

As set out above, price adjustment clauses or contingent payment arrangements in inter-company contracts that revisit the valuation based on outcomes, such that valuations are reflected in financial statements, should be respected for tax purposes. Without such measures, the number of mutual agreement procedure cases will rise significantly (and cases will potentially recur based on new outcomes in later years) 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 cost for businesses.

In other cases, where an adjustment is raised as the result of a tax authority audit, it will remain necessary to invoke mutual agreement procedures.

It would be helpful if the guidance included:

- Examples where a contractual payment or repayment is respected for tax purposes; and

- Examples of the operation of mutual agreement procedures in relation to hard-to-value intangibles, including where there are multiple years requiring adjustment.

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June 30, 2017

Mr. Jefferson VanderWolk
OECD Secretariat
Centre for Tax Policy and Administration
Organization for Economic Cooperation and Development
2, rue André Pascal
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FRANCE

Re: Comments on *Public Discussion Draft on BEPS Action 8: Implementation Guidance on Hard-to-Value Intangibles (dated 23 May-30 June 2017)*

Dear Mr. VanderWolk:

Deloitte Tax LLP ("Deloitte Tax"), a subsidiary of Deloitte LLP[1] ("Deloitte") appreciates the opportunity to submit comments regarding the Organization for Economic Cooperation and Development's (OECD's) *Public Discussion Draft on BEPS Action 8: Implementation Guidance on Hard-to-Value Intangibles* (the "Discussion Draft").

The comments contained herein are limited to comments on the principles that should underlie the implementation of the HTVI approach. As such, they are not intended to address the underlying HTVI guidance of October 5, 2015, formally incorporated in the OECD *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* ("TPG") in May 2016.

We have organized our comments in two related but distinct sections.

The first section deals with the guidance found at paragraphs 1 to 13 and 31 to the end of the Discussion Draft. This section is conceptual in nature, and focuses primarily on assessing whether the guidance achieves (or, when applied to the real world, is likely to achieve) an arm's length outcome, and adequately balances the concerns of tax administrations and taxpayers.

Tax administrations are concerned about the informational disadvantage they are under, as articulated in paragraph 5 of the Discussion Draft. Such information asymmetry can result in non-arm's-length outcomes favorable to

[1] Please see www.deloitte.com/us/about for a detailed description of our legal structure.

taxpayers. Taxpayers, on the other hand, are concerned about structuring their affairs and risks upfront (*ex-ante*) in a certain way, only to see tax administrations use the benefit of hindsight to undo that *ex-ante* allocation of risk with *ex-post* results beneficial to them. Such behavior by tax administrations can result in non-arm's-length outcomes when the accurately delineated transaction allocated the *ex-ante* risk to one party, but the *ex-post* return associated with the resolution of the risk is allocated to another party.

Both concerns are legitimate, and result in possible (substantial) deviations from an arm's length outcome, and in possible double taxation.

The second section deals specifically with the three examples discussed at paragraphs 14 to 30. The comments provided in that section are informed by the conceptual discussion of the first section.

The issue of information asymmetry between taxpayers and tax administrations, the clear prescription in the TPG that valuation should be done *ex-ante* based on information available *at that time*, and the resolution of said information asymmetry achieved by authorizing tax administrations to rely on *ex-post* outcomes to asses *ex-ante* valuation create one of the most complex and challenging areas of transfer pricing.

The length of our comments reflects the concerns we have that (i) the HTVI framework can be a blunt tool when not applied properly, and (ii) it is definitely a very complicated tool to be applied properly.

This challenge is further compounded by the fact that the OECD HTVI guidance will have to be implemented within the broader legal framework of countries that may be extremely different from that perspective.

Specifically, the exculpatory provisions of paragraph 6.193 of Chapter VI of the TPG apply within the broader domestic legal system of each country applying such guidance.

These legal systems can be vastly different (*e.g.*, civil law countries *versus* common law countries as a starting point). Hence, the law that controls which party has the burden of proof at what stage of the process, including whether a paragraph 6.193(i) rebuttal by a taxpayer rejected by a tax administration would even be subject to judicial review, will differ from country to country.

Given that paragraph 3 of the Discussion Draft clearly states that "*…This guidance is aimed at reaching a common understanding and practice among tax administrations on how to apply adjustments resulting from the application of the approach for HTVI. This guidance should improve consistency and reduce risk of economic double taxation,"* it is of particular importance for the OECD to realize that once an HTVI challenge is authorized in a particular transaction, the outcome of such challenge is not just driven by the OECD guidance that is on point, it is also driven by non-transfer pricing domestic law, including as it relates to discovery, admissibility of evidence, and burden of proof.

For the OECD to achieve its stated objective of consistency across countries and minimizing the risk of double taxation, it is therefore important to minimize the number of cases subject to HTVI challenges—HTVI challenges should be the exception, not the rule. The HTVI guidance should be conducive to resolving disputes through mechanisms provided in the HTVI guidance and the transfer pricing documentation rules, rather than through reliance on mechanisms external to the HTVI guidance and the transfer pricing documentation rules (such as BEPS Action 14, treaties and the domestic law of the jurisdictions involved).

It is important to include such affirmative statements in the HTVI implementation guidance, and the guidance should be conducive to achieve the objectives underlying these affirmative statements.

We urge the OECD to add examples showing how taxpayers can reasonably meet the intended standards of paragraph 6.193(i) without having to explicitly assign a probability to every possible foreseeable cash flow, and provide qualitative or quantitative support for every single probability selected. The current Discussion Draft does not adequately address the complete discretion tax administrations have to reject rebuttals by taxpayers under paragraph 6.193(i)(1) and (2) for good reason or no reason at all.

Both paragraphs 6.192 (authorizing HTVI) and 6.193 (exceptions to HTVI) are *standardless* provisions. There may have been intended standards underlying these paragraphs, but they are not memorialized in guidance. It is therefore critical that the HTVI implementation guidance provide explicit standards that tax administrations would be bound by to limit their discretion.

Our Recommendations section provides a self-contained summary of all recommendations Deloitte Tax is respectfully submitting to the OECD in response to its call for stakeholders' comments on the Discussion Draft.

Since the HTVI framework is available to tax administrations but not to taxpayers, and since the HTVI guidance of Chapter VI provides tax administrations with the grant of authority they need to use *ex-post* outcomes to assess *ex-ante* valuation, Deloitte Tax believes that the HTVI implementation guidance should focus primarily on ensuring that reasonable limits and boundaries are placed on the discretion afforded to tax administrations in that grant of authority, while still addressing the information asymmetry concern of tax administrations.

Deloitte Tax does not believe that sufficient limits and boundaries have been provided in the current draft.

The HTVI framework can be a blunt tool and result in large and unwarranted non-arm's-length adjustments. Deloitte Tax believes the OECD and Working Party 6 have made tremendous progress in articulating an approach that, if applied properly, is broadly consistent with the arm's length principle, and alleviates the information asymmetry tax administrations are facing with respect to HTVI—the stated purpose of the HTVI principles.

However, Deloitte Tax also believes that HTVI is a very challenging and complex area, and the Discussion Draft falls short of providing the necessary guidance to adequately protect taxpayers from arbitrary and unreasonable HTVI assessments.

In the interest of protecting the arm's length integrity of the HTVI guidance, it would therefore be extremely useful to further clarify specific elements of the implementation guidance, including through the addition of examples illustrating cases where a taxpayer provides sufficient evidence of robust financial projections to qualify for a paragraph 6.193(i) exemption from the HTVI framework, without having to spell out every single foreseeable cash flow and associated probabilities (an impossible and unreasonably costly task).

We appreciate this opportunity to share our views on this issue and hope you find our comments valuable to the discussion.

We look forward to continued collaboration with the OECD on this and other transfer pricing initiatives. Please feel free to contact Philippe at +1 202 220 2601 should you have any questions about this submission.

Very truly yours,

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## DELOITTE COMMENTS ON OECD'S DISCUSSION DRAFT ON BEPS ACTION 8 IMPLEMENTATION GUIDANCE ON HARD-TO-VALUE INTANGIBLES

### EXECUTIVE SUMMARY

This executive summary compiles the key takeaways from a rigorous analysis of the Discussion Draft presented in Section One below. Section Two of our comments complements Section One with additional specific comments regarding the examples provided in the Discussion Draft. The Recommendations section below summarizes our recommendations.

1. The concerns of tax administrations and taxpayers are legitimate concerns. Tax administrations are concerned about information asymmetry, and taxpayers are concerned about tax administrations' discretion to use the benefit of hindsight in unpredictable ways inconsistent with the arm's length principle.
2. The Discussion Draft provides guidance that is *necessary* to produce an arm's length HTVI adjusted outcome, but it does not provide guidance that is *sufficient* to ensure that only arm's length HTVI adjusted outcomes are possible.
3. The guidance in the Discussion Draft that is necessary to produce an arm's length HTVI adjusted outcome is the prescription that *ex-post* results be used solely to inform adjustments on the probabilities used in the *ex-ante* valuation. Such guidance needs to be kept.
4. The guidance in the Discussion Draft that is missing to provide sufficient conditions to produce an arm's length HTVI adjusted outcome is the prescription of *how* a tax administration would go from observing an *ex-post* outcome to an actual quantitative measure of what the adjusted *ex-ante* probabilities should be. As of now, tax administrations appear to have full discretion over that, including the discretion to adjust these probabilities in arbitrary ways. Therefore, and as more fully explained in our Recommendations section, Deloitte Tax recommends as follows:
    - The use of *ex-post* information to adjust probabilities in an *ex-ante* valuation is an extremely complicated and technical problem that requires reliance on mathematical tools (measure theory) that are not commonly used outside of very specialized applications. We strongly recommend that the OECD not pursue this path.
    - Instead, a standard should be added to currently standardless paragraph 6.192.
    - Similarly, a standard should be added to currently standardless paragraph 6.193.
    - Good faith efforts by taxpayers to develop contemporaneously documented details about how the *ex-ante* financial projection was arrived at, and specifically explaining how the probabilities were calculated, should be deemed to have eliminated the information asymmetry issue the HTVI framework is aiming to resolve. As long as that documentation is reasonable, *ex-post* results different from the

*ex-ante* valuation should *not* result in a presumption that the valuation should have been higher (or lower, for that matter).

- Only in cases when that contemporaneous documentation does not exist, or does not specifically address how the financial projection was arrived at, or how the probabilities were calculated, or is unreasonable, should the HTVI framework be authorized.
- Once the HTVI framework is authorized, and a tax administration proposes an HTVI adjustment that is a reasoned adjustment (*i.e.*, not merely a numerical adjustment unsupported by facts or analysis), a taxpayer should have a right to rebut that proposed adjustment.
- In the rebuttal phase, a taxpayer should have the right to use information that was available *ex-ante*, but also information that is *ex-post* available, but was not *ex-ante* available. Such rebuttal could include *ex-post* evidence from the open markets in the form of comparable data or other extraneous relevant evidence that could help achieve an arm's length resolution to the dispute.
- At that point, a tax administration should be compelled to evaluate the rebuttal in good faith. Should the tax administration conclude that the proposed HTVI adjustment is warranted (or a modified version after considering the rebuttal), a final reasoned adjustment may be imposed. Such final reasoned adjustment must provide a basis in facts or data, using the same data reliability requirements as those imposed by the tax administration on taxpayers to evaluate their rebuttal. Failure by a tax administration to provide such reasoned adjustment should result in no HTVI adjustment.

5. Regular review by the OECD of the HTVI framework, and regular peer reviews of HTVI adjustments should be implemented as a means to ensure that the framework is applied as intended -- the exception rather than the norm. Countries that overly rely on the HTVI framework to adjust intangible transfers should be subject to peer review of future proposed HTVI adjustments for a period of time. The peer review of HTVI adjustments should focus squarely on the three phases of the HTVI challenge outlined above.

# RECOMMENDATIONS

The following recommendations are designed to provide a more robust framework to implement the HTVI guidance of Chapter VI in a way that appropriately balances the concerns of taxpayers and tax administrations, while at the same time preserving the policy objectives of the HTVI framework. Thus, implementing the suggested recommendations involves changes in the HTVI implementation guidance only, *not* in the HTVI guidance of Chapter VI that was adopted as part of the BEPS final report published October 5, 2015, and officially incorporated into the OECD TPG in May 2016.

## RECOMMENDED CHANGES TO HTVI FRAMEWORK

Deloitte Tax recommends that the HTVI implementation guidance provide more structure to minimize the cases of HTVI transfers that could be subject to non-arm's-length HTVI adjustments under the current guidance. The proposed structure includes articulating a few basic standards that, if reasonably met, allow the information asymmetry between taxpayers and tax administrations to be resolved without resorting to an actual HTVI adjustment.

Because every HTVI challenge will crystalize during a transfer pricing audit, the transfer pricing audit is a natural starting point to articulate the first important standard that will reduce the number of cases when the tax administration may disagree with an *ex-ante* valuation, but that disagreement *does not* result in authorizing the tax administration to use *ex-post* evidence. All other valuation remedies available to a tax administration under the authorities of Chapter I, Chapter VI (other than HTVI), and other relevant chapters of the TPG to adjust the value of the HTVI transfer remain available to the tax administration.

- <u>Phase One</u>: Transfer Pricing Audit Phase
    - A tax administration requests a taxpayer's contemporaneous transfer pricing documentation concerning a transfer of intangible rights.
    - As a result of auditing the transfer pricing documentation, the tax administration concludes that the transfer of rights concerns an HTVI (within the meaning of paragraph 6.189).
    - <u>Recommended Standard</u>: If the transfer pricing documentation provided by the taxpayer (1) was developed contemporaneously with the HTVI transfer, (2) provides adequate details about how the *ex-ante* financial projection was arrived at, and (3) specifically explains how the probabilities were calculated, then such transfer pricing documentation should be deemed to have eliminated the information asymmetry issue the HTVI framework is designed to resolve. As long as the transfer pricing documentation is reasonable, *ex-post* results different from the *ex-ante* valuation should not result in a presumption that the valuation should have been higher (or lower. for that matter).

    - To evaluate whether the transfer pricing documentation is reasonable or not, the guidance should require the same standard of data reliability as is normally required for transfer pricing purposes, unless the data at issue concerns the probabilities used in the valuation. For such probabilities, the standard should be lower, because determining probabilities is inherently judgmental and in most cases there is insufficient external evidence to clearly support such judgments. The estimation of probabilities for valuation purposes almost always requires judgment calls that are at least somewhat subjective in nature. Requiring that data to meet standard reliability requirements would render any discounted cash flow valuation unavailable for taxpayers because of a lack of reliability of the probability data, but available to tax administrations for HTVI adjustment purposes.
    - Conforming adjustments should be made to the other sections of the TPG that address data reliability requirements.
    - Only in cases where the taxpayer does not reasonably meet the standard above should the tax administration have the authority to propose an HTVI adjustment under paragraph 6.192.
    - The proposed HTVI adjustment should be a reasoned adjustment; it should provide a basis in facts or data to explain why the HTVI adjustment is appropriate and should not simply rely on the presumption, unless the taxpayer fails to provide information that the tax authority needs to provide a reasoned adjustment.
- Phase Two: Rebuttal Phase (Paragraph 6.193)
    - Presented with a proposed HTVI adjustment, the taxpayer should have a right to rebut it. The rebuttal may rely on facts or data; it may contemplate information that was available *ex-ante*, as well as information that was not, but became available *ex-post*. The rebuttal may rely on evidence from the open market in the form of comparable uncontrolled transactions (internal or external), including evidence that uncontrolled taxpayers do not typically incorporate in financial projections.
    - Recommended Standards: The HTVI implementation guidance should provide reasonable standards tax administrations and taxpayers may rely on to evaluate whether the requirements of paragraph 6.193(i) have been met.[2]

[2] The standard may be less intuitive than the first one. However, it can be easily explained in the context of the first scenario in Example 1 in the Discussion Draft. In that scenario, the first commercial sales reflected in the *ex-ante* financial projection are expected to occur in Year 6. However, the first commercial sales are *ex-post* observed in Year 3. Since the taxpayer cannot show that earlier sales were considered in the financial projection, the conclusion of Example 1 in this first scenario is that an HTVI adjustment is warranted. This conclusion may be erroneous if in an uncontrolled valuation context it is highly unlikely that specific sales timing scenarios that are probability-weighted would be developed. There is little reason to do so. Savvy valuation professionals recognize that there is a chance of earlier sales, but they also recognize that there is a greater chance of delayed sales. The chances of delayed sales are typically much greater than those of

        - The first standard would provide that when a taxpayer reasonably establishes causality between a specific event that was either unforeseeable at the time of the HTVI transfer, or foreseeable at the time of the HTVI transfer but not accounted for in the financial projection because in uncontrolled comparable transactions it is not the practice to consider the impact of such a foreseeable event, and such event accounts for a substantial amount of the HTVI adjustment, then the taxpayer has met the standard of paragraph 6.193(i).
        - The second standard would provide that when a taxpayer reasonably establishes causality between a specific event that was foreseeable at the time of the HTVI transfer and accounted for in the financial projection but with a probability of one (i.e., treated as "certain" despite being uncertain), and such event accounts for a substantial amount of the HTVI adjustment, and the taxpayer can reasonably establish that adjusting the *ex-ante* probabilities would not materially change the *ex-ante* valuation because the increase in the *ex-ante* valuation due to the "upside" *ex-post* outcome would likely be offset by an equal decrease in the *ex-ante* valuation due to possible "downside" *ex-post* outcomes viewed *ex-ante*, then the taxpayer has met the standard of paragraph 6.193(i).
        - In addition, the OECD may want to consider defining the terms "foreseeable" and "unforeseeable" as they are used to characterize certain stochastic events such as financial crises, products launch dates in the future, unexpected regulatory changes, and many others. Such characterization greatly matters in the application of the HTVI guidance. For example, the OECD could include in the definition of an unforeseeable event that an event is unforeseeable if the probability of it occurring would not have a material impact on the valuation.
    - Adding standards to the implementation of paragraph 6.193 is of critical importance. Should the OECD disagree with those suggested herein, Deloitte Tax urges WP6 to consider alternative standards to provide some level of certainty as to how a taxpayer can realistically expect to benefit from the exception.
- <u>Phase Three</u>: HTVI assessment Phase

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earlier sales because businesses want to go as quickly to market as possible, and the assumption incorporated in the financial projection as to the date of the first commercial sales is the target date of the business to go to market with a commercial product. Therefore, it is typically conservative (meaning it lowers the valuation) to assign a probability of one in the financial projection to that target date. Thus, as discussed in Part Two, where we discuss Example 1, a correct HTVI adjustment accounting for the possibility of "earlier" sales but also of "delayed" sales may actually be negative, not positive. The second proposed safe harbor above would correctly get the taxpayer in Example 1 outside of an HTVI adjustment unless the taxpayer did account for the possibility of "delayed" sales, but did not account for the possibility of "earlier" sales.

- In response to the taxpayer's rebuttal, a tax administration should be compelled to evaluate in good faith the information, data, analysis, and arguments presented by the taxpayer. Should the tax administration conclude that the proposed HTVI is warranted (or a modified version after considering the rebuttal), a final reasoned adjustment may be imposed. Such final reasoned adjustment must provide a basis in facts or data, using the same data reliability requirements as those imposed by the tax administration on taxpayers to evaluate their rebuttal, unless the taxpayer fails to provide information reasonably available to the taxpayer upon which the tax authority could perform the analysis. Failure by a tax administration to be in a position to provide such reasoned adjustment should result in no HTVI adjustment.
- At that point, local laws, treaties, and BEPS Action 14 mechanisms would need to be relied upon to eliminate double taxation.

## RECOMMENDED LANGUAGE AND STATEMENTS

Our comments propose a number of adjustments to the language used in the Discussion Draft. These adjustments are summarized below, and are based on the results of our technical analysis, discussed in Section One.

1. Add a specific statement to the effect that "HTVI adjustments should be the exception and not the rule."
2. Add a specific statement to the effect that "The HTVI framework is not intended to substitute for the TPG in the case of an audit of an HTVI transfer; it merely complements the TPG when there is clear presumptive evidence that the taxpayer's valuation may not be robust."
3. Add a specific statement to the effect that "When both the *ex-ante* financial projection used by the taxpayer, and the HTVI adjustment to the *ex-ante* financial projection based on *ex-post* evidence proposed by the tax administration are reasonable, deference should be given to the *ex-ante* financial projection."
4. Add a specific statement to the effect that "The arm's length principle is a valuation principle, not an anti-avoidance tool. Since the HTVI framework aims at producing arm's length results, it is a tool designed to assist the assessment of the *ex-ante* valuation, not to conclude that there was an attempt at avoidance because of a difference between *ex-pos*t outcomes and *ex-ante* valuation."
5. Add a specific statement to the effect that "A non-zero difference between *ex-post* results and the *ex-ante* projection is to be expected, and does not, in and of itself, provide presumptive evidence that the *ex-ante* probabilities should be adjusted." Note that this statement is a more concise version of the statistically correct statement that "A non-zero difference between *ex-post* results and the *ex-ante* projection is to be expected with probability one. The *ex-ante* probability that the *ex-post* result will be equal to the *ex-ante*

financial projection is a zero probability event; it will almost surely not occur."

6. An important element of guidance at paragraph 6 uses language such as "…or cash flows are significantly higher…," and "…projected income or cash flows used…should have been higher…." It does not say "…or cash flows are significantly higher or lower…," nor does it say "...projected income or cash flows used…should have been higher or lower…." The OECD may want to consider adjusting the language to encompass "higher" *and* "lower," because on each side of an HTVI transfer is a tax administration with opposing views of whether *ex-post* evidence is, or not, presumptive of *ex-ante* mispricing.
7. Provide definitions of (i) conditional projection, (ii) financial projection, and (iii) forecast, and explain that a financial projection is constructed from conditional projections that are probability-weighted and added up. Also, explain that a financial projection is different from a forecast. Providing these definitions is particularly important in order to eliminate controversy stemming from different understandings of what a financial projection is and is not. This distinction would go a long way toward advancing the OECD's goals. The OECD may wish to leverage from the definitions provided in Section One of these comments.
8. Qualify the statement at paragraph 6 of the Discussion Draft that if "the actual income or cash flows are significantly higher than the anticipated income or cash flows on which the pricing was based, *then there is presumptive evidence that the projected income or cash flows used in the original valuation should have been higher.*" [Emphasis added]. If the italicized sentence is meant to articulate a statistically true statement, it should be struck from paragraph 6, because it is incorrect. A coin landing on "heads" does not provide any presumptive evidence that the odds of landing on heads in a fair coin is greater than 50 percent. However, if the italicized sentence is not meant to be true as a statistical matter, but is meant as the grant of authority for tax administrations to do something that otherwise they would not be authorized to do (because incorrect), and authorize such behavior to achieve the desired policy outcome of reducing information asymmetry by forcing taxpayers into rebuttal and extensive disclosure of information, then it should be made clear at paragraph 6 (the heart of the Discussion Draft).
9. Maintain in final guidance the sentence at paragraph 6 that prevents tax administrations from using the *ex-post* actual result to perform the adjustment: "However, it would be *incorrect* to base the revised valuation on *the actual income or cash flows without also taking into account the probability*, at the time of the transaction of the income or cash flows being achieved." [Emphasis added].
10. Add a requirement providing that a tax administration is authorized to change the form of payment of an otherwise accurately delineated transaction (that language is critical), if and only if it is the *only* way to resolve statute of limitation issues. Any application of paragraph 6.185 that is predicated on behavioral arm's length considerations (*e.g.,* taxpayers acting

at arm's length would not have structured their form of payment as a lump sum, they would have structured it as sales contingent), is a Chapter I accurate delineation of transaction issue or a commercial rationality issue, not an HTVI framework issue, and should be treated as such.

11. Add a specific statement to the effect that "Any adjustment up (down) to probabilities made by a tax administration in the course of an HTVI assessment must include an explanation of which other probabilities in the *ex-ante* valuation were decreased (increased). Probabilities of mutually exclusive events must add up to one."
12. Add a specific statement to the effect that "An HTVI adjustment that involves a change in the form of payment in an otherwise accurately delineated transaction will always include a portion of value that is related to the change in the form of payment itself, rather than related to adjustments to the probabilities of the *ex-ante* valuation. That portion of the adjustment should be excluded from the calculation of transfer pricing penalties when applicable, to the extent permissible under local laws."

## RECOMMENDED ADDITION OF EXAMPLES

The use of examples is particularly important regarding the application of the HTVI guidance of Chapter VI of the TPG. The addition of examples (or modification of existing examples) could prove extremely useful in memorializing and illustrating the intent of the use and application of the HTVI framework, without forcing tax administrations and taxpayers to go back to its "legislative history" (*e.g.*, various non-consensus discussion drafts that have been issued, comments submitted to the OECD, public consultation held at the OECD, and public statements and pronouncements offered by the OECD Secretariat).

To balance the needs of the HTVI guidance to empower tax administrations to alleviate the information disadvantage they face while preserving taxpayer rights, it would be helpful to add more examples illustrating cases whereby a taxpayer provides a tax administration with sufficient information to avoid being subject to an HTVI adjustment.

1. Add an example illustrating a fact pattern whereby the taxpayer successfully avoids the HTVI framework by developing contemporaneous transfer pricing documentation that reasonably meets the standard articulated in our recommendations above at the transfer pricing audit phase. The example should illustrate the type of information the OECD TPG expects taxpayers to proffer regarding the probabilities used in the *ex-ante* valuation.
2. Add two examples illustrating a fact pattern where the taxpayer fails to meet the previous standard, but meets the two standards articulated in our recommendations above at the rebuttal phase to escape an HTVI adjustment pursuant to an application of paragraph 6.193(i).
3. Add an example specifically illustrating how a tax administration is expected to adjust a probability used in the *ex-ante* financial projection relying on information that was available to the taxpayer at the time of the ex-ante valuation, but using the presumptive evidence provided by the *ex-post*

results. The example should specifically address how while the probabilities of the *ex-post* results are increased (explain how this is done), the tax administration appropriately decreased the probability of other *ex-ante* possible results, so that the probabilities of mutually exclusive events adds up to one (explain how this is done, and based on what information).

4. Add an example specifically illustrating a fact pattern where the HTVI adjustment does not result in a change in the form of payment of an otherwise accurately delineated transaction because, even though some of the years subject to the HTVI adjustment are closed, others are still open, and the total HTVI adjustment may be made in those years to reduce the discrepancy below the threshold contained in 6.193(iii).

# SECTION ONE

## INTRODUCTION

In the case of intangibles that fall within the definition of HTVI at paragraph 6.189 of the TPG, and under certain conditions, tax administrations are authorized under paragraph 6.192 to "consider *ex post* outcomes as presumptive evidence about the appropriateness of the *ex ante* pricing arrangements." More specifically, if "the actual income or cash flows are significantly higher than the anticipated income of cash flows on which the pricing was based, then there is presumptive evidence that the projected income or cash flows used in the original valuation should have been higher." Discussion Draft at paragraph 6.

The purpose of the HTVI guidance of the 2016 TPG at paragraphs 6.189 to 6.195 is as follows: "The guidance protects tax administrations from the negative effects of information asymmetry by ensuring that tax administrations can consider *ex post* outcomes as presumptive evidence about the appropriateness of the *ex ante* pricing arrangements. However, that taxpayer has the ability to rebut such presumptive evidence…." Paragraph 2.

Paragraph 6.192 of the 2016 TPG authorizes tax administrations to apply the HTVI guidance, not taxpayers. In addition, none of the language used at paragraph 6.192 suggests that taxpayers can compel a tax administration to apply the HTVI guidance (in cases favorable to taxpayers): "In these circumstances, the tax administration *can consider* ex post outcomes as presumptive evidence…" [Emphasis added].

The HTVI guidance of Chapter VI of the 2016 TPG was clearly intended by the OECD to be consistent with the arm's length principle articulated in Chapter I of the same guidelines. In fact, paragraph 2 of the Discussion Draft cites paragraph 6.188 of the 2016 TPG when it says that the HTVI approach is an "*approach consistent with the arm's length principle* that tax administrations can adopt to ensure that tax administrations can determine in which situations the pricing arrangements as set by the taxpayers are at arm's length and are based on an appropriate weighting of the foreseeable developments or events that are relevant for the valuation of certain hard-to-value intangibles, and in which situations this is not the case." [Emphasis added].

Tackling the asymmetry between the information available to taxpayers and the absence of information available to tax administrations, in a way consistent with the arm's length principle, is thus at the heart of the HTVI guidance of Chapter VI of the 2016 TPG (paragraph 5).

The implementation guidance contained in the Discussion Draft can therefore be evaluated by reference to its effectiveness in achieving the stated goals of the HTVI guidance of resolving the information asymmetry between a tax administration and a taxpayer, without sacrificing the arm's length nature of the outcome.

While the primary concern of tax administrations with respect to HTVI may be information asymmetry, another significant concern of tax administrations is articulated at paragraph 11 of the Discussion Draft, which recognizes that some countries may encounter difficulties in implementing the HTVI approach due, for example, to short audit cycles or a short statute of limitation.

Therefore, the three main concerns of tax administrations the HTVI guidance and HTVI implementation guidance (collectively the "HTVI framework") should address are:

- TA1: Whether or not the HTVI framework is consistent with the arm's length principle;
- TA2: Whether or not the HTVI framework is effective at resolving the information disadvantage tax administrations face relative to taxpayers; and
- TA3: Whether or not the HTVI framework is effective at providing tools for tax administrations to implement an HTVI adjustment to overcome short audit cycles, short statutes of limitations, or other impediments arising from domestic laws.

On the other hand, the four main taxpayer concerns the HTVI framework should address are:

- TP1: Whether or not the HTVI framework is consistent with the arm's length principle;
- TP2: Whether the two tax administrations applying the HTVI framework on each side of an intangible transfer will reach the same conclusion under paragraph 6.189 that a specific transfer of rights concerns an HTVI;
- TP3: Whether the two tax administrations applying the HTVI framework on each side of the HTVI transfer will reach the same conclusion under paragraph 6.193 that the taxpayer has or has not met one of the HTVI exceptions; and
- TP4: Whether the two tax administrations will have access to an effective mechanism to resolve disputes and double taxation arising from differences in interpretation of the HTVI guidance at paragraphs 6.189 and 6.193 or from differences in valuation. BEPS Action 14, "*Making Dispute Resolution Mechanisms More Effective*" is thus relevant to address that concern.

Although TA1 and TP1 appear to be the same concern tax administrations and taxpayers share about ensuring that the HTVI framework is conducive to producing results consistent with the arm's length principle, the taxpayers' perspective in evaluating the Discussion Draft will reflect the fact that the HTVI guidance at paragraph 1.692 is an asymmetrical grant of substantial authority to tax administrations. No authority is granted to taxpayers.

Therefore, in connection with concern TP1, taxpayers will ask themselves whether or not the Discussion Draft provides sufficient safeguards against applications of HTVI likely to result in material deviations from an arm's length result. The HTVI framework does not benefit taxpayers in the sense that when favorable, a taxpayer cannot compel a tax administration to apply the HTVI framework, and the framework itself is not intended to provide taxpayers a benefit.

Tax administrations, on the other hand, through the paragraph 6.192 grant of authority to apply the HTVI framework, are effectively trading off TA1, TA2, and TA3. In other words, a tax administration may be much more willing to tolerate the costs of deviating from the arm's length principle if the portion of those costs borne by the tax administration is more than offset by the benefits of achieving TA2 and TA3.

To illustrate the point above, consider a paragraph 6.192 HTVI adjustment to an HTVI transfer, combined with a change in the form of payment from lump sum to contingent under paragraph 6.185 (as authorized by paragraph 6.192). Paragraph 6.185 effectively authorizes a tax administration to reallocate *ex-ante* risk between a licensor and a licensee, because an upfront lump-sum payment is systemically riskier for a licensee (systemically less risky for a licensor) than an ongoing contingent payment. One of the reasons a tax administration could invoke paragraph 6.185 in the context of a paragraph 6.192 HTVI adjustment is that the statute of limitations for years subject to the adjustment has run out. This is concern TA3 of tax administrations. Therefore, even if such *ex-post* change of *ex-ante* risk allocation is questionable from an arm's length perspective (we examine this issue below), tax administrations may be willing to accept such deviations because without them, the HTVI framework would not be effective in addressing its primary reason for being (TA2: information asymmetry) because of failure to address concern TA3 (overcome domestic laws issues).

The policy trade-off between scope of applicability of the arm's length principle and leveled playing field between tax administrations and taxpayers has been a trade-off that countries participating in the BEPS process have been willing to make. The proposed "special measures" of the December 2014 non-consensus discussion draft on risk and recharacterization specifically said as much.

It should be noted that Deloitte Tax is not taking any position on the policy itself. The scope of our remaining comments is limited to discussing the likely effectiveness of the Discussion Draft in achieving the desired policy outcome.

The remainder of our Section 1 comments is organized as follows. We start by discussing the conditions under which the use of *ex-post* information to evaluate an *ex-ante* valuation is consistent with the arm's length principle. This discussion is conceptual and relies on economic and statistical principles. Once the conditions under which the use of *ex-post* information to evaluate an *ex-ante* valuation is consistent with the arm's length principle are established, we examine the specific language of the Discussion Draft that addresses each of the concerns of tax administrations -- TA1 to TA3 -- and of taxpayers -- TP1 to TP4 -- through that prism.

## CONSISTENCY BETWEEN THE HTVI FRAMEWORK AND THE ALS

Paragraph 2 of the Discussion Draft asserts that "Section D.4 addresses the treatment of hard-to-value intangibles ("HTVI") for transfer pricing purposes. That Section contains an "approach *consistent with the arm's length principle* that tax administrations can adopt to ensure…." (paragraph 6.188)…The guidance protects tax administrations from the negative effects of information asymmetry…." [Emphasis added].

The HTVI approach itself provides that in certain circumstances "tax administrations are entitled to consider *ex post* outcomes as presumptive evidence about the appropriateness of the ex ante pricing arrangements." Paragraph 6.

The Discussion Draft is silent as to how, mechanically, a tax administration is authorized to use such *ex-post* presumptive evidence about the appropriateness of the *ex-ante* pricing arrangement to actually effectuate a transfer pricing adjustment.

However, still at paragraph 6, the Discussion Draft provides two important elements of guidance:

- "Where, for example, the actual income or cash flows are significantly higher than the anticipated income or cash flows on which the pricing was based, then there is presumptive evidence that the projected income or cash flows used in the original valuation should have been higher, and that *the probability-weighting of such an outcome requires scrutiny,* taking into account what was known and what could have been anticipated *at the time of entering* into the transaction involving the HTVI." [Emphasis added]; and
- "However, it would be *incorrect* to base the revised valuation on *the actual income or cash flows* without also t*aking into account the probability*, at the time of the transaction of the income or cash flows being achieved." [Emphasis added].

It is noteworthy that the first important element of guidance at Paragraph 6 listed above uses language such as "…or cash flows are significantly higher…," and "…projected income or cash flows used…should have been higher,…," it does not say "…or cash flows are significantly higher or lower…," nor does it say "...projected income or cash flows used…should have been higher or lower…." The OECD may want to consider adjusting the language to encompass "higher" and "lower," because on each side of an HTVI transfer is a tax administration with opposing views on what *ex-post* evidence is presumptive of *ex-ante* mispricing. One such view is an *ex-post* outcome *higher* than the *ex-ante* value, the other view is an *ex-post* outcome *lower* than the *ex-ante* value.

Paragraph 6 thus clearly indicates that whichever mechanism is used by a tax administration to evaluate an *ex-ante* HTVI transfer using *ex-post* results, it must be through an adjustment to the probabilities used in the *ex-ante* valuation (first bullet point), and it cannot be through an adjustment of the probability of the actual result to one (second bullet point)—*i.e.*, setting the *ex-ante* probability of the *ex-post* result in the adjusted *ex-ante* valuation used to calculate the HTVI adjustment to a probability of one (and thus the probability of all other *ex-ante* possible results to zero, because probabilities have to add up to one).

To illustrate what paragraph 6 really says, consider a simple example that will be used throughout the remainder of our comments.

Consider a simple HTVI transfer of rights whereby a licensor grants a licensee the rights to further develop a piece of HTVI. The licensee will have to incur risky research and development (R&D) costs to develop the licensed HTVI into a commercial product reasonably expected to generate cash inflows at a certain date. At the time the transfer takes place, the licensee faces the following elements of uncertainty that affect the objectives of its business:

- Will the R&D activity be successful in the sense that the technical risk associated with the R&D activity is successfully resolved?[3]
- Will the R&D costs required to resolve the technical risk of R&D be aligned with the expectations at the time of the transfer?
- From the date of the transfer, how many years without cash inflows will elapse before the first commercial product using the developed HTVI starts generating cash inflows?
- Once the first commercial product using the developed HTVI starts generating cash inflows, what is the reasonably anticipated last date at which the last commercial product using the developed HTVI or any of its derivatives ends generating cash inflows? (This goes to something that can loosely be defined as the "economic life" of the HTVI rights that were transferred, not economic life of products).
- For every year from the first year the first commercial product using the developed HTVI starts generating cash inflows, until the last year the last commercial product using the developed HTVI or any of its derivatives ends generating cash inflows, what are the possible cash inflows that can be reasonably anticipated given all foreseeable events, and what are the probabilities of each possible cash inflow? And
    - All risks related to commercialization of the product(s) need to be considered when examining these possible cash inflows and associated probabilities. For example, in the pharmaceutical drug fact pattern examined in the examples provided by the OECD and discussed in Section Two of our comments, risks associated with

[3] Technical risk of R&D is the first risk associated with certain types of R&D development projects to resolve. To carry technical risk, the R&D project must exhibit the following features: (i) the R&D project has a non-zero probability of failing (at the time the R&D project is terminated, no monetization of the asset resulting from the R&D investments is reasonably expected), and (ii) the R&D project has a non-zero probability of being successful, but if successful, no cash inflows are reasonably expected unless additional investments are made to monetize the asset resulting from the R&D activity. In other words, there are no cash inflows reasonably expected from the resolution of technical risk, whether the project fails or is successful (failure and success as defined above). So economically, the information that has been revealed through the resolution of the technical risk is whether or not the R&D costs incurred to date have sunk or have not sunk (within the meaning economists ascribe to the word "sunk."). The appropriate discount rate to discount R&D expenses exposed to technical risk is the risk-free rate of return. This is the lowest discount rate that can be used to discount R&D costs, and is appropriate only for those R&D costs exposed to technical risk, as defined above. Most meaningful research investments in highly innovative industries will carry a significant amount of technical risk. Costs associated with pure research rather than applied research will typically carry more technical risk. Research costs will typically carry more technical risk than development costs.

expectations about the competitive landscape in Year 6 (expected date of commercialization) would be important to consider (*e.g.*, competitors faster to market with alternative products, competitors with better products).

- For every year after the technical risk of the R&D activity is resolved, what are the possible cash outflows that will be necessary to enhance or maintain the HTVI that was transferred and further developed by the licensee given all foreseeable events, and what are the probabilities of each possible such cash outflows?

Since all of these elements of uncertainty affect the objectives of the licensee's business, they are economically significant risks to be assumed for transfer pricing purposes (within the meaning of risk defined at paragraph 1.71 of Chapter I of the TPG).

Obviously, a multitude of factors, many of which are outside the control of the HTVI transaction participants, will cause the resolution of the cash-flow uncertainties listed above. For example, an unexpected financial crisis may cause the first commercial product release to be delayed because of a strategic supplier going out of business.[4]

The purpose of this example is to illustrate the HTVI concepts and evaluate under what circumstances they are consistent with generating arm's length results; we will therefore assume that the accurately delineated transaction, including the form of payment selected by licensor and licensee, is such that the licensee assumes (within the meaning of paragraph 1.94 of Chapter I of the TPG) all of the economically significant risks listed above. In other words, the licensee controls (within the meaning of paragraph 1.65 of Chapter I of the TPG) all the relevant economically significant risks in the controlled transaction, and is entitled to the upsides and the downsides of the HTVI risk outcomes. Chapter I at paragraph 1.94.

Control over risks is not the focus of this discussion, and when we discuss changes of form of payment, it will be important to discuss what such changes in form of payment do to an *ex-ante* accurately delineated transaction.

### The Arm's Length Ex-Ante Valuation

In a valuation context, the meaning of a few terms of art must be clarified to ensure a meaningful discussion.

[4] In this context, although outside the control of the participants in the HTVI transfer, purely exogenous risks such as a financial crisis can be managed through the use of risk mitigation strategies. Such risk mitigation strategies may involve the decision to qualify more than one supplier of strategic inputs to increase the likelihood that if one goes out of business, another one can step in and minimize product delays and associated cash inflow delay. The framework of Chapter I of the 2016 TPG focuses on where the decision to qualify more than one supplier is made in the MNE (*i.e.*, control over the decision) to determine who assumes the financial crisis risk for transfer pricing purposes; it does *not* focus on where the actual functions required to qualify more than one supplier are performed (*i.e.*, management of what was decided through the exercise of control).

The term *ex-ante* is used to refer to the exact time the transfer of right is legally binding on the participants. Any and all risks related to the transfer that resolve after the exact time the transfer of right is legally binding on the participants have to be assumed for transfer pricing purposes by one or both participants. The written contract that is executed memorializes that allocation of risks.

The term *ex-post* is used to refer to any and all times that follow the exact time the transfer of right is legally binding on the participants, and the information set they have available contains information that was not available ex-ante.

In that framework, even if no new information about the possible resolution of the economically significant risks is available *ex-post* for a period of time, the information set of the participants does contain new information. Indeed, the fact that there is no new information that has transpired is valuable information in its own right, and may result in the updating of the *ex-ante* probabilities of the various relevant risks.[5]

A conditional projection is a projection that is conditioned on a particular resolution of a specific stochastic event. For example, in the sequential tossing of two coins, the possible resolutions of the stochastic event are: heads followed by heads, heads followed by tails, tails followed by heads, and tails followed by tails. Suppose that the associated payoffs are all zero unless the event "tail followed by tail" occurs, in which case the payoff is 100. In this example, we have four conditional projections, namely, one associated with each of the four possible resolutions of the underlying stochastic event of sequentially tossing two coins. Three of these four financial projections have zero cash flows associated with them, one has a positive 100 cash flow associated with it.

A financial projection is the *ex-ante* probability-weighted average of all possible cash flows for each and every year there is a reasonable expectation of cash flows. A financial projection that is meaningful in a valuation exercise is not a forecast.[6]

The purpose of a financial projection is not to predict which of the possible cash flows will occur. Its purpose is to average all possible cash flows, giving more weight to those more likely to occur and less weight to those less likely to occur.

It should thus be clear that developing a meaningful financial projection for transfer pricing valuation purposes is not about identifying possible cash flows. The possible cash flows range from minus infinity to plus infinity.[7] Developing a meaningful

[5] Bayesian learning describes a particular mechanism by which *priors* about probabilities related to stochastic events are updated as new information (including no information) becomes available. There is a substantial economic literature dealing with such updating of probabilities of stochastic events when new information becomes available. Bayesian learning models are commonly used by economists.

[6] The Cambridge Dictionary defines a financial forecast as "a statement of what a company's financial position *is likely to be in the future*, for example what its costs, income, and profits will be." [Emphasis added].

[7] Extreme negative cash flows may seem unreasonable and unnecessary to consider in the normal course of exploitation of HTVI, but (i) that is a probabilistic statement in and of itself, and (ii) the probability of such an event needs to consider a non-normal course of business such as those arising,

financial projection for transfer pricing purposes is about identifying the true probability of each possible cash flow, many of which may have zero probability of occurring.

In valuation parlance, pinpointing one specific cash flow out of all possible ones is pinpointing to a conditional projection (see definition above)—the projection conditional on a particular resolution of the *ex-ante* risks. *Ex-ante*, the probability of such conditional projection occurring is less than one. Meaningful valuation can be done using a conditional projection (*i.e.*, cash flows that are not probability-weighted), but this is outside the scope of this discussion, as the valuation guidance provided by the OECD in the 2016 TPG at Sections D.2.6.3 and 2.6.4 in Chapter VI appears to deal primarily with the traditional discounted cash flow (DCF) approach that uses financial projections, not conditional projections.

Finally, the arm's length value of the transfer is defined as the present value of the financial projection adequately discounted to reflect the systemic risks the cash flows probability-weighted in the financial projections are exposed to.

It follows that the numerator of the arm's length value of the transfer captures the diversifiable portion of the economically significant risks through the probabilities weighing of each conditional cash flow, while the systemic portion of the economically significant risks is captured in the denominator (the discount rate).[8]

In our numerical example, assume that the taxpayer understands (or is appropriately advised) that all cash flows from minus infinity to plus infinity are theoretically possible as a result of the HTVI transfer, and thus the challenge of constructing a financial projection is to best estimate the unknown and unobservable true probability distribution in order to assign the most reliable weights to these cash flows in the financial projection. Such true probability distribution is almost in all cases unknown and unobservable; however, there are exceptions—this is a fact and circumstances issue.

From a practical standpoint, assume the taxpayer determines that it is reasonable to develop three conditional projections -- one pessimistic, one neutral, and one optimistic -- and develop a financial *projection* by estimating the true probability of these three conditional projections occurring, and calculating the resulting probability-weighted average.

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for example, from adverse legal judgments as a result of a catastrophic resolution of risk (*e.g.*, the product using the HTVI kills people). Such catastrophic events are often foreseeable, they just carry an extremely low probability of occurrence. Similarly, extremely positive cash flows ("windfall type" cash flows) may seem unreasonable and unnecessary to consider, but for the same reasons as above such cash flows are foreseeable, they just also carry an extremely low probability of occurrence.

[8] The words "non-diversifiable," "systemic," "systematic," and "market correlated" are all synonymous. They describe risks that cannot be eliminated through diversification. In other words, it is the portion of economic risk that affects all values in the economy. The more project-specific or company-specific a risk is, the less likely it has a large systemic portion. Technical risk is entirely diversifiable and has no systemic portion. That is why the appropriate discount rate for such risk is the risk-free rate of return.

Assume that the pessimistic projection is such that the resolution of the technical risk of the development of the HTVI is adverse, and the R&D costs incurred to date become economically sunk. Assume that conditional projection is negative $1,000.

Assume that the neutral projection is such that the resolution of the technical risk of the development of the HTVI is favorable, and the resolution of the non-technical risk of the development of the HTVI is such that the conditional projection is positive $500.[9]

Finally, assume that the optimistic projection is such that the resolution of the technical risk of the development of the HTVI is favorable, and the resolution of the non-technical risk of the development of the HTVI is such that the conditional projection is positive $5,000.

After careful consideration, including internal (contemporaneously documented) discussions with employees from various departments, as well as through a qualitative weighing of various quantitative industry data points relevant to the evaluation of the likelihood of the three conditional projections (also contemporaneously documented), their *ex-ante* probabilities are determined to be 0.6, 0.1, and 0.3, respectively.

It follows that the financial projection is:

$$Financial\ Projection = -0.6 \times \$1{,}000 + 0.1 \times \$500 + 0.3 \times \$5{,}000 = \$950$$

Notice our earlier point that a financial projection is not about predicting the future. The financial projection above does not predict any of the three conditional cash flows developed by the licensee, it merely averages them in a very specific way (probability-weighted).

Predicting the future is about taking a position on which of the three cash flows will occur. With probability 0.6, the pessimistic conditional projection is the most likely to occur, which would make the prediction that the pessimistic outcome would unfold the most likely. However, most taxpayers will provide the $5,000 conditional projection when asked for financial projections. Taxpayers typically provide "optimistic" projections when asked for a financial projection.

The *ex-ante* valuation is then performed by discounting the financial projection at a discount rate appropriately reflecting the systemic risk the financial projection is exposed to. Assume without loss of generality that the appropriate discount rate is 11.11 percent.[10]

The *ex-ante* value of the HTVI transfer is thus:

$$Value\ of\ HTVI\ Transfer = \frac{\$950}{(1 + 11.11\%)} = \$855$$

[9] These conditional projections of cash flows include all cash inflows minus all cash outflows.

[10] The discount of 11.11 percent is arbitrarily selected so that the financial projection of $950 is discounted to a round number of $855 for ease of calculation.

Assume that the licensee develops contemporaneous transfer pricing documentation consistent with the prescriptions of BEPS Action 13 of the final report of October 5, 2015, as adopted in the relevant local laws of the two tax jurisdictions at the opposite ends of the HTVI transfer.

The narrative of the valuation above mimics, in a much simplified way, the challenges facing taxpayers in this type of HTVI transfer: (i) how do you reduce all the possible cash-flow outcomes of R&D into something manageable? In the example above, the licensee opted to develop three conditional projections; (ii) how do you reasonably determine the probabilities of the conditional projection you develop when in most instances these *ex-ante* probabilities are unknown and unobservable for both taxpayers and tax administrations, as well as for market participants?[11] In the example above, only qualitative assessments support the probabilities selected, because no market data or other reliable and verifiable quantitative information is available.

We can now examine what happens *ex-post.*

### The HTVI Challenge

Assume that the technical risk of the R&D resolved favorably, and the resolution of the non-technical risk of the development of the HTVI is such that the actual financial result of the licensee is \$5,000—the optimistic scenario played out despite having only a 30 percent *ex-ante* probability of occurring.

The taxable income resulting from the transfer reported on the tax return of the licensor was \$855, yet the *ex-post* value of the transfer to the licensee is \$5,000.

Concerned about this apparent undervaluation of the HTVI transfer, and emboldened by the assertion in the Discussion Draft at paragraph 6 that: "Where, for example, the actual income or cash flows are significantly higher than the anticipated income or cash flows on which the pricing was based, *then there is presumptive evidence that the projected income or cash flows used in the original valuation should have been higher*, and that the probability-weighting of such an outcome requires scrutiny, taking into account what was known and what could have been anticipated at the time of entering into the transaction involving the HTVI," [emphasis added], the tax administration of the country of the licensor initiates a transfer pricing audit.

In response to the audit, the taxpayer turns over the contemporaneous documentation it developed at the time of the transfer. Such documentation contains explanations of how the conditional projections and associated probabilities were developed.

In the taxpayer's mind, relief from paragraph 6.192 is warranted (i) under paragraph 6.193(i)(1), because she believes to have robust contemporaneous

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[11] This observation dampens the assertion that taxpayers have a significant information advantage over tax administrations concerning the probabilities of possible cash flows, especially for green-field investment projects, or disruptive innovation-type investment projects, when the reality is that nobody has much information about the true probabilities of cash flows.

documentation of how the financial projection was constructed, and (ii) under paragraph 6.193(i)(2), because the financial projection did *ex-ante* consider the outcome that was *ex-post* observed.

Because at least one of the exculpatory provisions of paragraph 6.193 has been met at 6.193(i), the taxpayer takes the position that it is excused from an HTVI challenge.

Since we want to determine the conditions under which an HTVI challenge by a tax administration is consistent with the arm's length principle, we will abstract from any other transfer pricing controversy that may arise in connection with the HTVI transfer. Therefore, we will assume that (i) the method selected by the taxpayer to value the transfer is not in dispute, (ii) the discount rate used by the taxpayer is not in dispute (given the form of payment selected *ex-ante*), (iii) the horizon over which cash flows are expected is not in dispute (this is the reason we work with a two-period example), and (iv) the reliability of the conditional projections is not in dispute because tax administrations understand that grouping an infinite number of possible cash flows into discrete conditional projections is the only practical way to do a valuation.[12]

Note that the number of conditional projections developed by a taxpayer is in and of itself irrelevant insofar as the reliability of the analysis is concerned. In our example, we assumed that the taxpayer reduced the infinite number of foreseeable cash flows from infinity to three: pessimistic, neutral, and optimistic.

We will now establish that the resulting valuation is equally reliable using three scenarios or two. Call these two scenarios low and high.[13]

Assume that the low conditional projection is negative $500 (the sum of the pessimistic and neutral projection), and the high conditional projection is positive $5,000.

Whether we separately deal with three conditional cash-flow projections $A = -\$1{,}000$, $B = \$500$, and $C = \$5{,}000$ under the probability measure $p^A = 0.6$, $p^B = 0.1$, and $p^C = 0.3$, or we deal with two cash flow projections $(A + B) = -\$500$ and $C = \$5{,}000$ under the alternative probability measure $\widetilde{p}^{A+B}$ =0.736

[12] There are strong statistical arguments to be made that estimating the probability distribution of a smaller number of larger groupings of possible cash flows is more reliable than estimating the probabilities of a larger number of smaller groupings. This is not just because estimating a few discrete probabilities is easier and more reliably done than estimating several of those, it is also, and more importantly, because of the Central Limit Theorem. It is beyond the scope of these comments to explain the relevance of the Central Limit Theorem to the HTVI framework, but it is certainly within the scope to urge the OECD to not issue guidance suggesting that it is more reliable to develop a larger number of more granular conditional projections than a smaller number of less granular conditional projections; in general, it is not.

[13] This result generalizes to any number of scenarios. An analysis based on the development of 100 scenarios captured in 100 conditional projections is intrinsically no more and no less reliable than one based on the development of five or two scenarios captured in five or two conditional expectations, respectively, as long as the probabilities used in the construction of the final projection are calculated properly.

and $\tilde{p}^C$=0.263, we obtain the same financial projection of $950, and we obtain the same correct value of $855 for the HTVI transfer:

$$Financial\ Projection = -0.736 \times \$500 + 0.263 \times \$5{,}000 = \$950$$

$$Value\ of\ HTVI\ Transfer = \frac{\$950}{(1 + 11.11\%)} = \$855$$

Thus, as long as the probability measure applied to these cash flows is calculated correctly, the number of conditional cash-flow projections explicitly considered in the construction of the financial projection (whether two: A andB, or one (A + B) combined) has no bearing on the reliability of the analysis.

The reliability of a valuation is entirely dictated by the reliability of the probability measure used in relation to the discount rate.[14]

To illustrate that point, assume the risk-free rate of return is 2 percent. Going back to our example, assume that the true probability measure $p^A = 0.6, p^B = 0.1$, and $p^C = 0.3$ is unknown and unobservable (which is often the case in the real world). Then, we could perform a reliable valuation by using the risk-neutral valuation measure $q^{A+B}$=0.75045 and $q^C$=0.24955 along with the risk-free rate of return of 2 percent. In this case, the financial projection under the risk-neutral probability measure will be different than under the true probability measure, but because it is the combination of the probability measure used in valuation and of the discount rate used that determines the reliability of the valuation, as long as that combination is correct, a reliable valuation will prevail:

$$Financial\ Projection = -0.75045 \times \$500 + 0.24955 \times \$5{,}000 = \$872$$

$$Value\ of\ HTVI\ Transfer = \frac{\$872}{(1 + 2\%)} = \$855$$

Although the points we just illustrated are general valuation points that are not specific to HTVI, those points have fundamental implications in the context of HTVI, and in assessing whether or not the guidance in the Discussion Draft is conducive to producing arm's length results when applied.

Thus, for an HTVI assessment to be consistent with the arm's length principle, it is necessary that it be an adjustment to the probabilities assigned in the *ex-ante* valuation to the conditional projections. The adjustment itself can be proposed by a tax administration expressed in dollars or in a percentage increase in the value of the HTVI transfer; the presentation just masks the underlying adjustment, which is

[14] Changes in probability measures are commonly performed in valuation. The most famous of these is the celebrated option pricing formula of Black & Scholes, which uses the risk-neutral probability measure instead of the "true" probability measure of the stochastic event. Any textbook on Measure Theory covers the techniques used to perform changes in probability measures. In many valuation problems, the "true" probability measure of the stochastic event is unknown, unobservable, and without hope of being reliably estimated. A traditional DCF valuation can therefore not be reliably performed. However, by using the risk-neutral probability measure, a reliable valuation can be done using the risk-free rate of return as the appropriate discount rate along with the risk-neutral probability. We illustrate such a change in measure and discount rate in our numerical example.

*not* to cash flows, it is to probabilities. The Discussion Draft is very clear at paragraph 6 (and in the examples) about that. However, what the Discussion Draft does not say is that although this is a necessary requirement, it is not sufficient.

It is not sufficient because not just any adjustment to the *ex-ante* probabilities teasing out information from the *ex-post* results will be consistent with the arm's length principle.

Consider in our example a tax administration that would take the position that because we did observe the optimistic scenario to play out *ex-post*, it must have been more likely than was accounted for in the *ex-ante* valuation. The resulting proposed adjusted financial projection takes the form of an adjustment to the relative probabilities of the three scenarios as follows:

$$\begin{aligned} Adjusted\ Financial\ Projection &= -0.3 \times \$1{,}000 + 0.2 \times \$500 + 0.5 \times \$5{,}000 \\ &= \$2{,}300 \end{aligned}$$

Probabilities are thus adjusted in an arbitrary and unpredictable way, with no explanation provided or required as to why the probabilities are adjusted as they are by the tax administration.

Taxpayers may be willing to concede in good faith that tax administrations should be allowed to cure their information disadvantage by being authorized to examine information not available at the time of the transfer; however, they are not likely to agree to a resulting adjustment based on subjective assessments by a tax administration.[15]

The resulting proposed adjusted HTVI value is as follows:

$$Adjusted\ Value\ of\ HTVI\ Transfer = \frac{\$2{,}300}{(1 + 11.11\%)} = \$2{,}070$$

The proposed HTVI assessment is thus $1,215.

The reason such adjustment is clearly not consistent with the arm's length principle is that the tax administration's hypothetical reasoning is incorrect.

The optimistic outcome had a 30 percent probability of occurring, and the mere observation of that *ex-post* result does not provide any useful information to assess the reliability of the 30 percent probability.

[15] In addition, for counties adopting the OECD TPG in domestic law, legal certainty principles (including predictability of law) may prevent the HTVI framework to survive judicial scrutiny if the application of the guidance is so subjective that a qualified reasonable person would not be in a position to understand how to regulate her behavior to comply with the law. Finally, the guidance should be objective enough that a compliant taxpayer would understand the potential financial exposure of an uncertain tax position in connection with an HTVI transfer. Without any guidance as to how *ex-post* results inform the probability of an *ex-ante* valuation, such an understanding is impossible to achieve.

The analogy with a fair coin toss would be that after observing one coin toss that landed on heads, we adjust the *ex-ante* probability of heads to 70 percent and tails to 30 percent—clearly a nonsensical conclusion.[16]

Since neither the HTVI guidance at paragraph 6.192 nor the Discussion Draft provide any guidance as to how *ex-post* evidence is to be used to adjust *ex-ante* probabilities in a way consistent with the arm's length principle, and because it is not correct to claim that information on probability distribution can be directly inferred from a one-time realization of risk. Deloitte Tax urges the OECD to remedy this by adopting the recommendations proposed in the Recommendations section, and by clarifying the following language:

- Qualify the statement at paragraph 6 of the Discussion Draft that says that if "the actual income or cash flows are significantly higher than the anticipated income of cash flows on which the pricing was based, *then there is presumptive evidence that the projected income or cash flows used in the original valuation should have been higher*." [Emphasis added]. If the underlined sentence is meant to articulate a statistically true statement, it should be struck from paragraph 6 because it is incorrect. The coin landing on heads does not provide any presumptive evidence that the odds of heads in a fair coin is greater than 50 percent. However, if the underlined sentence is not meant to be true as a statistical matter, but is meant as the grant of authority for tax administrations to do something that otherwise they would not be authorized to do (because incorrect), and authorize such behavior in order to achieve the desired policy outcome of reducing information asymmetry by forcing taxpayers into rebuttal and extensive disclosure of information, then it should be made clear at paragraph 6 (the heart of the Discussion Draft); and
- Maintaining in final guidance the sentence at paragraph 6 that prevents tax administrations from using the *ex-post* actual result to perform the adjustment: "However, it would be *incorrect* to base the revised valuation on *the actual income or cash flows without also taking into account the probability*, at the time of the transaction of the income or cash flows being achieved." [Emphasis added].

In our numerical example, this sentence prevents tax administrations from calculating the adjusted value of the HTVI transfer as done below:

$$Value\ of\ HTVI\ Transfer = \frac{\$5{,}000}{(1 + 11.11\%)} = \$4{,}500$$

Conceptually, such an adjustment can be reconciled with the arm's length principle (see the necessary but not sufficient condition established earlier) if and only if the presumptive assertion of the tax administration to support the adjustment is that the probability of the optimistic outcome should have been one in the *ex-ante* valuation, and that the probability of the two other alternatives (pessimistic and

[16] By definition of a fair coin, the probability of landing on heads and tails is 50 percent each.

neutral) should have been zero. But that cannot possibly be the case. Indeed, the definition of an HTVI requires that the *ex-post* cash flows seen *ex-ante* be "…highly uncertain, making it difficult to predict the level of ultimate success of the intangible at the time of the transfer." Paragraph 6.189. Therefore, the above adjustment is not consistent with the arm's length principle and the guidance should be kept.

### ALS and Changes in Form of Payments

Paragraph 6.192 authorizes a tax administration to rely on the authority of 6.185 to effectuate a change in the *ex-ante* agreed form or payment. The reason a tax administration may need to change the form of payment to effectuate an HTVI adjustment is that the statute of limitation may have run on years during which lump-sum payments (installments) for the HTVI transfer were made. In such a case, a tax administration would be authorized to change the form of payment from lump sum (installments) to sales contingent applied to sales occurring in years with an open statute of limitation.

However, as currently drafted in the HTVI framework, a tax administration appears to be authorized to change the form of payment of an otherwise accurately delineated transaction even if the statute of limitations of the years relevant to the HTVI adjustment are still open. This is because the change of payment form authorized at paragraph 6.192 relies on the authority to change form of payment provided at paragraph 6.185. Limitations on such authority at paragraph 6.185 do not include any conditions on whether or not a statute of limitations has run its course or not, nor is there any such additional requirement limiting the scope of applicability of paragraph 6.185 when applied in the HTVI framework.

Deloitte Tax suggests that such additional requirement providing that a tax administration is authorized to change the form of payment of an otherwise accurately delineated transaction (that language is critical), if and only if it is the only way to resolve statute of limitations issues. Any application of paragraph 6.185 that is predicated on behavioral arm's length considerations (*e.g.,* taxpayers acting at arm's length would not have structured their form of payment as a lump sum, they would have structured it sales contingent), is a Chapter I accurate delineation of transaction issue, not an HTVI framework issue.

Clearly, changing the form of payment from lump sum (installments) to sales contingent implies a different *ex-ante* allocation of risk between licensor and licensee. A lump-sum payment (installments) is riskier to a licensee (less risky to a licensor) than a sales contingent payment. The risk we are talking about in the previous statement is systemic; it is therefore captured in the discount rate, not in the probabilities used to construct the financial projection.

It follows that, in an accurately delineated transaction involving a lump-sum form of payment (installments), an HTVI assessment effectuated through a change in the form of payment must be calculated through both a change in the *ex-ante* probabilities (the HTVI assessment itself), and a change in the discount rate that reflects the change in the form of payment (to effectuate the HTVI assessment).[17] This is a necessary condition for an HTVI assessment involving a change in form of payment to be consistent with the arm's length principle.

Going back to our numerical example, assume that the tax administration adjusts the *ex-ante* probabilities (probability measure) of the three conditional projections (pessimistic, neutral, optimistic) from $p^A = 0.6$, $p^B = 0$, and $p^C = 0.3$ to $\bar{p}^A = 0.3$, $\bar{p}^B = 0.2$, and $\bar{p}^C = 0.5$ as a result of applying the HTVI framework.

The adjusted financial projection is thus:

$$\begin{aligned} Adjusted\ Financial\ Projection &= -0.3 \times \$1{,}000 + 0.2 \times \$500 + 0.5 \times \$5{,}000 \\ &= \$2{,}300 \end{aligned}$$

For the sake of this discussion, we will assume that the change in probability measure is warranted—based on observing the *ex-post* result of $5,000, the careful examination of the probability measure $p$ by the tax administration identifies relevant information that was known at the time of the HTVI transfer, but that was not incorporated appropriately in the probability measure used by the taxpayer. Therefore, assume that the taxpayer acting in good faith conceded the use of the probability measure $\bar{p}$ for the sake of calculating the HTVI assessment.

Further assume that the accurately delineated transaction provided for a lump-sum payment of the entire HTVI value of $855 in the first year of the transfer.

Finally, assume that the HTVI assessment proposed by the tax administration is based on the difference between the value that was paid, $855, and the following value:

$$Adjusted\ Value\ of\ HTVI\ Transfer = \frac{\$2{,}300}{(1 + 11.11\%)} = \$2{,}070$$

The proposed HTVI assessment is thus $1,215.

Is such an adjustment consistent with the arm's length principle?

It is not.

It is not, because if 11.11 percent is the appropriate discount rate when the form of payment for the HTVI transfer is a lump sum, it cannot possibly be the appropriate discount rate when the form of payment of the HTVI transfer is sales contingent.[18] The appropriate discount rate when the form of payment of the HTVI transfer is sales contingent is lower than when it's a lump sum.

There is thus a first step that is required to calculate an HTVI assessment consistent with the arm's length principle.

[17] For an analysis of how discount rates are adjusted to reflect different forms of payment (or different systemic risks in general), see Philippe G. Penelle, "What is a Risk-Adjusted Return?," Bloomberg BNA *Transfer Pricing Report*, Vol. 25, March 9, 2017.
[18] *Ibid* for proof of that statement.

That first step is to recalculate, at the probability measure $p$ used by the taxpayer, the value of the HTVI transfer under the *ex-ante* alternative agreement between licensor and licensee that the form of payment will be sales contingent rather than lump sum.

Remember that this *ex-post* recharacterization of the *ex-ante* allocation of risk between licensor and licensee in an otherwise accurately delineated HTVI transfer is authorized *only* because of statute of limitations issues—not because a finding that the transaction was not accurately delineated by the taxpayer in the first place. If it were, it would be a Chapter I issue, not an HTVI issue.

Assume that the appropriate discount rate when the form of payment is sales contingent rather than lump sum is 8 percent instead of 11.11 percent. It follows that:

$$Redelineated\ Value\ of\ HTVI\ Transfer = \frac{\$950}{(1+8\%)} = \$880$$

Then in the second step, the adjusted value of the HTVI transfer in the accurately delineated transaction with sales contingent form of payment can be calculated as the difference between the redelineated value of the HTVI transfer calculated above and the adjusted redelineated value of the HTVI transfer below:

$$Adjusted\ Redelineated\ Value\ of\ HTVI\ Transfer = \frac{\$2{,}300}{(1+8\%)} = \$2{,}130$$

The arm's length proposed HTVI assessment is thus $1,250. The total proposed adjustment is $2,130 (taxable value) minus $855 (reported on tax returns) or $1,275. The difference between the total proposed adjustment and the proposed HTVI assessment has two components, namely $1,250 of "real" HTVI adjustment and $25 of adjustment that should not be counted as part of any transfer pricing penalty regime.

The $25 of additional adjustment is the portion of the adjustment that relates to the change in the form of payment, and the resulting value of the incremental risk a lump-sum payment places on a licensee *vis-a-vis* a sales contingent payment. We assumed in the example that the HTVI transfer was accurately delineated with a lump-sum form of payment. The tax administration was authorized to make that change in form of payment to deal with closed years—not because the taxpayer did not meet its burden as far as the accurate delineation of the transaction is concerned. See paragraphs 6.185 and 6.192.

There is therefore no reason to include the $25 in the calculation of transfer pricing penalties in connection with the HTVI assessment. Many countries that have transfer pricing penalty regimes base the amount of penalties due on the size of the assessment.

The HTVI framework should make it clear in its implementation guidance that transfer pricing penalties should not be assessed on any portion of an HTVI-related assessment that pertains to a change in the form of payment in an otherwise accurately delineated transaction.

Because our comments attempt to provide a balanced view of the challenges the HTVI framework creates for tax administrations and taxpayers, it is important to note that the following proposed HTVI adjustment is neither consistent with the arm's length principle, nor does it provide the licensor with the full value it is *ex-ante* entitled to, given the change in the form of payment:

$$Adjusted\ Value\ of\ HTVI\ Transfer = \frac{\$2{,}300}{(1 + 11.11\%)} = \$2{,}070$$

In such an adjustment, not properly correcting the discount rate for the change in payment form, there is $130 of value the licensor is entitled to, and the tax administration of the licensor's jurisdiction is entitled to tax, left on the table.

The resulting $1,215 assessment is lower than the arm's length assessment of $1,275 by $60. Of that $60, $25 should be protected from penalties (if applicable).

## TAX ADMINISTRATION CONCERNS

We will now use the lessons learned from the previous analysis, and discuss whether the HTVI framework addresses the various concerns of tax administrations and taxpayers.

<u>TA1</u>: *Whether or not the HTVI framework and implementation guidance is consistent with the arm's length principle*.

Tax administrations are concerned that they may lack the information required to audit the arm's length nature of an HTVI transfer valuation performed potentially several years in the past. This concern relates to the quality of the information, not just its availability.

Our discussion so far has made it clear that (i) the grant of authority under paragraph 6.192 of the 2016 OECD TPG is so broad, and the safeguards in the Discussion Draft so limited, that any adjustment -- whether from a non-arm's-length result to an arm's length result, or from an arm's length result to another arm's length result, or from a non-arm's length result to another non-arm's length result, or from an arm's length result to a non-arm's length result -- is possible, and (ii) only the most extreme form of an adjustment to a non-arm's length outcome is explicitly rejected (see discussion immediately before this section)—these adjustments that result in collapsing all probabilities in the *ex-ante* valuation to zero other than the probability of the observed *ex-post* result which is set by the tax administration at one. We will come back to this discussion when we address taxpayers' concern TP1.

We thus concluded that the guidance currently provided in the Discussion Draft is necessary to ensure the consistency of the HTVI framework with the arm's length principle (adjustment on probabilities), but it is not sufficient (no guidance on how to adjust probabilities in an arm's length fashion). The Discussion Draft currently does not limit the adjustments to the "realistic" *ex-ante* probabilities.[19] Therefore,

[19] The word "realistic" in this context is meant to refer not to the true probabilities that are unknown and unobservable, but to the best estimate of these unknown probabilities participants in the same HTVI transfer would have used when presented with the same information available to the taxpayer

every conceivable probability distribution can be applied by a tax administration on the conditional projections to construct the adjusted financial projection in the course of an HTVI adjustment, subject to perhaps the requirement that the result cannot exceed the *ex-post* outcome itself. The only constraint faced by a tax administration in selecting a particular probability distribution to base the HTVI adjustment on is that it has to be a conceivable probability distribution, *i.e.*, the probabilities of mutually exclusive events have to add up to one.

In other words, a conscientious application of the current guidance will capture all arm's length results of an HTVI assessment—the probability distributions among all conceivable probability distributions that are either the "true" probability distribution (unknown and unobservable), or the probability distribution(s) uncontrolled participants in the same HTVI transfer would have used in the *ex-ante* valuation , but also a large number of non-arm's-length results—all other probability distributions that are conceivable.

Since tax administrations have the discretion to select any probability distribution they wish from the set of all conceivable probability distributions, they can select an arm's length one if they so desire, but they do not have to (the Discussion Draft does not currently compel them to do that). We therefore conclude that the current Discussion Draft does provide what tax administrations need with respect to TA1.

<u>TA2</u>: *Whether or not the HTVI framework is effective at resolving the information disadvantage tax administrations face relative to taxpayers*.

In an almost tautological way, the answer to that question is *no*. The analogy to the toss of a coin illustrated the notion that observing the outcome of one toss of a coin does not provide any meaningful information in and of itself to update beliefs about the *ex-ante* probabilities.[20]

However, in an almost equally tautological way, the answer to that question is *yes*. The HTVI framework is a framework that can be used by a tax administration to compel a taxpayer to produce information on an *ex-post* basis that otherwise would likely not be produced through the audit process and standard transfer pricing documentation requirements. If that information is not produced and the *ex-post* result cannot be explained, tax administrations can assess the HTVI transfer. If a taxpayer elects not to engage in the *ex-post* production of information with a tax administration (either because not documented *ex-ante* and not available, or for any

at the time of the *ex-ante* valuation. These "realistic" probabilities can often be far different from the true probabilities.

[20] Probabilities are conditioned on an information set available at the time the probabilities are estimated (they are not directly observable). Probabilities can be updated when the information set changes. Observing one realization of the risk does change the information set that was available at the time of the transfer. However, without specifying the mechanism by which the information set is affected by observing an ex-*post* result, and by which the updated information set translates into a probability measure (*e.g.*, Bayesian updating) that satisfies all requirements for a legitimate probability measure (see, for example, Patrick Billingsley, "*Probability and Measure*", Anniversary Edition, 2012, John Wiley & Sons, Inc., one of the classic textbooks used by financial engineers), the resulting adjustment to probabilities will generally not be consistent with the arm's length principle.

other reason), the information asymmetry is thus resolved by the tax administration's authority to assess the HTVI transfer.

In addition to the point above, because taxpayers know, at the time of the HTVI transfer, that the HTVI framework will apply to the transaction, and understand that they can benefit from the exculpatory provisions of paragraph 6.193, the framework clearly also incentivizes taxpayers to develop and produce more robust contemporaneous documentation than would otherwise be the case. The information asymmetry is thus also partially resolved through the incentives it creates.

We conclude that the HTVI framework is thus effective at helping resolve the information disadvantage tax administrations face relative to taxpayers.

TA3: *Whether or not the HTVI framework is effective at providing tools for tax administrations to implement an HTVI adjustment to overcome short audit cycles, short statute of limitations or other impediments arising from domestic laws.*

Our discussion of changes in form of payments made it clear that the authority tax administrations have under paragraph 6.192 to rely on paragraph 6.185 in the context of an HTVI challenge to re-allocate the *ex-ante* risk in an otherwise accurately delineated transaction directly addresses TA3, and is likely to put pressure on TA1.

The answer to the question is therefore that *yes* the HTVI framework appears to be effective at providing tools for tax administrations to implement an HTVI adjustment to overcome short audit cycles, short statute of limitations or other impediments arising from domestic laws.

In addition, from a tax administrations' perspective, the possible trade-off between TA3 and TA1 in a real world application of HTVI is consistent with the stated policy objective of allowing, in some specific cases, and under specific circumstances, deviations from the arm's length principle when seen as impeding the eradication of BEPS.

The conclusion of our analysis of tax administrations concerns is that for a tax administration unwilling to trade-off TA1 for TA2 or TA3, the HTVI framework is inadequate, for the exact same reason it is inadequate for taxpayers (see TP1 below)—the current Discussion Draft *does not* provide adequate guidance to restrict the space of adjusted probability distributions to *only* the arm's length outcomes (the guidance provides *necessary* but not *sufficient* conditions to achieve that).

We now turn to our analysis of taxpayers concerns.

### TAXPAYER CONCERNS

TP1: *Whether or not the HTVI framework is consistent with the arm's length principle*.

We concluded earlier that the guidance currently provided in the Discussion Draft is necessary to ensure the consistency of the HTVI framework with the arms' length principle (adjustment on probabilities), but it is not sufficient (no guidance on how to adjust probabilities in an arm's length fashion). In other words, we said, a conscientious application of the current guidance will pick up *all* arm's length results of an HTVI assessment, but *also* a large number of non-arm's-length results.

Our conceptual discussion asserted that without the provision of additional guidance limiting the ability of tax administrations to use *ex-post* results to adjust the probabilities used in an *ex-ante* valuation in arbitrary and non-arm's-length ways, TP1 concerns are legitimate.

Since it is unreasonable to expect that either tax administrations or taxpayers will have access to the expertise required to apply the techniques required to correctly update probabilities under a change in information set (*e.g.*, Bayesian learning), we do not recommend that WP6 go down that road.

Instead, to address this legitimate taxpayer concern, and recognizing the practical consequences of guidance that needs to be administered in the real world, we urge the OECD to adopt the recommendations proposed by Deloitte Tax in the Recommendations section.

It remains an open question whether or not taxpayers acting at arm's length in an HTVI transfer controlled by guidance that is insufficient to prevent the creation of incremental systemic risk seen on an *ex-ante* basis would treat such regulatory risk as an economically significant risk (within the meaning of Chapter I), and price it (in the discount rate).

Because an HTVI adjustment under the current Discussion Draft may or may not affect the systemic risk of the transaction (see our conceptual discussion), it is conceivable that, at arm's length, such portion of the systemic risk could be traded on an *ex-ante* basis by the parties to the transaction.[21]

Along the same reasoning, it also remains an open question whether or not taxpayers acting at arm's length would adjust their *ex-ante* probabilities of each conditional projection considered in the financial projection to reflect the likelihood that such conditional projection would be arrived at through an HTVI adjustment, rather than through the resolution of every other risk reflected in the probability measure.

The answer to this question may depend on a number of facts and circumstances of the actual HTVI transfer, including the jurisdictions involved, but it is not too difficult to think of common fact patterns that may lead at arm's length to such adjustments in the probability measure.

<u>TP2</u>: Whether the two tax administrations applying the HTVI framework on each side of the intangible transfer will reach the same conclusion under paragraph 6.189 that a specific transfer of rights concerns an HTVI; and

<u>TP3</u>: Whether the two tax administrations applying the HTVI framework on each side of the HTVI transfer will reach the same conclusion under paragraph 6.193 that

[21] That is, the *ex-ante* contract would treat the regulatory risk like any other systemic risk effectively connected to the HTVI transfer, and price it as such in the *ex-ante* valuation. Since neither party to the transfer controls the risk outcome (tax administrations do), such a contract has economic substance.

the taxpayer has or has not met the requirements to qualify for one of the HTVI exceptions.

These concerns are both about the likelihood that the guidance will result in consistent outcomes when interpreted by tax administrations with opposite objectives. The consolidated taxable income in an HTVI transfer is fixed and thus the taxing rights granted to the tax administrations on each side of the transfer must be a zero sum game, or the transfer results in double taxation.

The avoidance of double taxation is one of the OECD's paramount policy objectives.

TP2 is a legitimate concern in that the definition of an HTVI at paragraph 6.189 is, to some degree at least, subjective. Some intangible transfers clearly concern HTVI because they display a few clear elements present in the definition of an HTVI. However, for many intangible transfers, such determination may not be all that obvious, and paragraph 6.189 has to be interpreted by reference to the specific facts and circumstances of the rights transferred.

TP3 is not only a legitimate concern, it is, from a practical standpoint, a significant one. Our discussion of TA1 and TP1 clearly articulated that, as the Discussion Draft currently stands, a tax administration has limitless ability to use e*x-post* outcomes to adjust *ex-ante* probabilities as they see fit and without being bound by any standards.

In other words, both paragraphs 6.192 (authorizing HTVI) and 6.193 (exceptions to HTVI) are standardless provisions. It is therefore critical that the HTVI implementation guidance provide standards that tax administrations are bound by and that limit their discretion. *See* our Recommendations section.

Without such standards, not only are taxpayers and tax administrations without much guidance to ensure a consistent outcome in their respective analyses concerning HTVI, but so are tax administrations on each side of the transaction.

Deloitte Tax therefore urges the OECD to address TP2 and TP3 in additional guidance.

<u>TP4</u>: Whether the two tax administrations will have access to an effective mechanism to resolve disputes and double taxation arising from differences in interpretation of the HTVI guidance at paragraphs 6.189 and 6.193 or from differences in valuation. BEPS Action 14, "Making Dispute Resolution Mechanisms More Effective," is thus relevant to address that concern.

Taxpayers will evaluate that concern not just from the perspective of whether or not the ultimate resolution of any difference between tax administrations (TP2, TP3, or valuation-related) will be resolved without resulting in double taxation, but also, and perhaps more importantly, whether or not the broader construct of the HTVI framework, Action 14 guidance, and local domestic rules will work together in a harmonious way to reach an acceptable outcome that allays TP1 concerns and does not result in double taxation without requiring unreasonable and unnecessary time and resources commitments when having reasonably complied with all relevant guidance.

The process of adoption of Action 14 dispute resolution mechanisms and of the Multilateral Instrument (MLI) is complicated, and varies widely as a result of the specifics of each country's bilateral treaties. In and of itself, the MLI and binding arbitration may help alleviate some TP4 concerns in some cases, but overreliance on that mechanism to resolve HTVI-related issues may be misguided.

In addition, the domestic general legal framework, including non-tax related areas of the law such as contract law, rules of discovery, rules governing burden of proof, and rules governing the access and scope of access to judicial review of decisions by the executive branch of government vary widely across the 100+ countries participating in the inclusive framework. The United States, for example, is a common law country with a clear separation between the legislative, executive, and judiciary branches of the government. Checks and balances protect taxpayers with broad access to judicial review, and provide a system designed to shift the burden of proof in a very specific way. Discovery rules are such that information used by one party in arguing its case *must* be made available to the opposing party and is subject to scrutiny, challenges, and rebuttals.

Not all countries have such robust legal frameworks. Not all countries are common law countries. Certain countries do not have a clear separation of the various branches of government; others may have a clearer separation but without appropriate checks and balances. Certain decisions made by the executive may not fall within the judiciary's scope of jurisdiction. Certain information used by a tax administration to assess a taxpayer may not be required to be disclosed to taxpayers. For example, some countries allow tax administrations to use private information about other similarly situated taxpayers to assess a controlled transaction (this may include so-called "secret" comparables).

It's important to keep in mind these differences in legal systems. Disputes should be minimized in the first place to avoid taxpayers having to rely on dispute resolution mechanisms that their country may or may not have signed up for, and without having to face the consequences of the idiosyncrasies of their local domestic laws, for better or for worse.

For the OECD to achieve its stated objective of consistency across countries and minimize the risk of double taxation, it is therefore important to minimize the number of cases subject to HTVI challenges—HTVI challenges should be the exception, not the rule.

Such affirmative statement would be very important to put in writing in the HTVI implementation guidance.

## CONCLUSION

Based on our conceptual analysis of the Discussion Draft (presented in the first part of Section One), and based on the above analysis of both tax administrations and taxpayers concerns with respect to the HTVI framework, Deloitte Tax believes that the current Discussion Draft does not adequately address the concerns of tax administrations, nor does it adequately address the concerns of taxpayers.

The legitimacy of the concerns of both taxpayers and tax administrations is not at issue.

The use of *ex-post* results to adjust an *ex-ante* valuation that is consistent with the arm's length principle is an extremely technically complicated issue.

Updating of probabilities as new information comes in cannot be done using a frequency approach to probabilities. The frequency approach to probabilities would require multiple independent draws from the same underlying probability distribution to make meaningful adjustments to the *ex-ante* probabilities used. Tax administrations only observe one such *ex-post* realization of the *ex-ante* risk, not multiple independent draws.

Therefore, the frequency approach to probabilities is useless in that context.

Conversely, an alternative approach to probability that is useful in that context comes from mathematics and measure theory. Financial engineers and economists dealing with complex valuation problems do use that approach to probability, which provides a well-accepted way to update probabilities when new information becomes available (*e.g.*, Bayesian learning). However, as a practical matter, it is not effective for the OECD to further explore that avenue to complement the guidance in the current Discussion Draft, given the complexity of the subject matter.

Deloitte Tax does not suggest that WP6 pursue such exploration, but Deloitte Tax does suggest that the OECD take into consideration the fact that the problem it is facing of guiding tax administrations in the proper use of *ex-post* information to adjust *ex-ante* probabilities is not a new problem -- it has been extensively addressed in the financial economics literature. This literature confirms that (i) the frequency approach to probability cannot solve the problem, (ii) the measure theory approach does solve the problem, (iii) measure theory is too complicated to be applied by taxpayers and administered by tax administrations, and (iv) guidance to address taxpayers' concerns should therefore focus on providing additional guidance along the lines proposed in our Recommendations section.

The OECD should also reflect in its guidance that the arm's length principle is a valuation principle, not an anti-avoidance tool. Since the HTVI framework aims at producing arm's length results, it is a tool designed to assist the assessment of the *ex-ante* valuation, not to conclude that there was an attempt at avoidance because of a difference between *ex-post* outcomes and *ex-ante* valuation. As extensively discussed above, an observed difference between the two will occur almost surely;

[22] the HTVI framework is thus helpless at detecting avoidance behaviors without detecting outcomes not resulting from any nefarious behaviors.

Since the HTVI framework is available to tax administrations but not to taxpayers, and since the HTVI guidance of Chapter VI provides tax administrations with the grant of authority they need to use *ex-post* outcomes to assess *ex-ante* valuation, Deloitte Tax believes the HTVI implementation guidance should focus primarily on ensuring that reasonable limits and boundaries are placed on the discretion afforded to tax administrations in that grant of authority, while still addressing the information asymmetry concern of tax administrations.

Deloitte Tax does not believe that sufficient limits and boundaries have been provided in the current draft.

In addition, it would be of great importance for the OECD to clearly state that the arm's length principle requires the assessment of the *ex-ante* valuation by reference to the stochastic events and associated probabilities that uncontrolled taxpayers would have considered on an *ex-ante* basis in a comparable transfer of HTVI rights, not by reference to the true probabilities of the underlying events.

Those true probabilities are generally unknown and unobservable for market participants (regardless of whether or not they are related). Therefore, any *ex-post* information observable to a tax administration that reveals information useful to increase the accuracy of the *ex-ante* valuation, but not available at the time of the *ex-ante* valuation cannot be used against the taxpayer because uncontrolled participants to the same HTVI transfer would not have had access to that information allowing more precise estimates of the true probabilities.

In certain HTVI transfers, the probabilities used by uncontrolled participants may be widely off the true unknown and unobservable probabilities. Applying the HTVI framework on their valuations that are definition arm's length would therefore often result in HTVI adjustments under the current guidance.

The appropriate behavior of a tax administration is to (i) use the *ex-post* information to challenge the probabilities used in the *ex-ante* valuation, and (ii) evaluate through that challenge whether or not uncontrolled participants engaged in the same transfer of HTVI rights would have selected probabilities

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[22] This statement is a precise statistical statement within the meaning of "almost surely" in probability theory. The term "almost surely" is used in probability theory to describe an event that has probability one of occurring, but where the set of complementary events is *not empty* but has probability zero. The equivalent concept in Measure theory is "almost everywhere." The important point, and the difference between "surely" and "almost surely" (or "everywhere" and "almost everywhere"), is that although a "sure" event also has probability one of occurring, its set of complementary events is *empty*. Thus a "sure" event is *always* observed *ex-post*, but an "almost sure" event, despite having *ex-ante* probability one of occurring, may not be the *ex-post* outcome—an event in the complementary set that had *ex-ante* probability zero of occurring may actually be the observed *ex-post* outcome.

consistent with the probabilities the taxpayer used at the time of the *ex-ante* valuation.

## SECTION TWO

This section relies on the analyses contained in Section One to comment on the examples proffered by the OECD in the Discussion Draft as illustrative of the practical implementation of an HTVI adjustment.

None of the examples illustrate the determination under paragraph 6.189 as to whether or not the transfer concerns an HTVI, it is assumed in each that it does.

Similarly, all the examples assume that "a transfer pricing adjustment is warranted for the transaction." This assumption is critically important because the way it is written appears to mean that the mere observation that the *ex-post* result of the HTVI transfer is different from the *ex-ante* valuation, the common thread in the examples, is sufficient for a tax administration to automatically have the authority to apply the HTVI framework.

This appears to be inconsistent with the prescription at paragraph 6 that "tax administrations are entitled to consider ex-post outcomes *as presumptive evidence* about the appropriateness of the ex-ante pricing arrangements." [Emphasis added]. Considering *ex-post* outcomes that differ from the *ex-ante* valuation as presumptive evidence about the appropriateness of the *ex-ante* pricing arrangement is not the same as inferring from such difference that a transfer pricing adjustment is warranted.

It may have been the case (see discussion of Example 1 below) that the assumption meant by the OECD is along the lines of "after considering the appropriateness of the *ex-ante* pricing arrangement based on the presumptive evidence provided by the *ex-post* result, assume that the application of paragraph 6.192 results in a transfer pricing adjustment."

Clarifying what the assumption is really meant to say is important because, as currently written, and together with the statement at paragraph 6 analyzed in Part One stating that when "the actual income or cash flows are significantly higher than the anticipated income of cash flows on which the pricing was based, *then there is presumptive evidence that the projected income or cash flows used in the original valuation should have been higher*" [emphasis added] the guidance could reasonably be interpreted as a direct inference of mispricing from any observed difference between *ex-post* outcomes and e*x-ante* valuation.

Because a financial projection is not a forecast, *ex-post* outcomes will almost surely be different from the *ex-ante* valuation. Thus, it should be clearly acknowledged that it is almost surely the case that the *ex-ante* financial projection will differ from the *ex-post* outcome. *See* discussion in Part One. It is therefore important not to have language that suggests that any difference between *ex-post* outcome and *ex-ante* valuation *automatically* results in an HTVI adjustment unless paragraph 6.193(iii) applies, and the taxpayer escapes the adjustment because the difference is less than 20 percent (or another exception applies).

## Example 1 Scenario A

This example concerns an HTVI transfer resulting in the first sales of a pharmaceutical compound in year 3 rather than in year 6 as assumed in the *ex-ante* valuation. The uncertain event in question, at the time of the transfer, was the date at which Phase III trials would be concluded.

The Discussion Draft states in paragraph 19, "The taxpayer cannot demonstrate that its original valuation properly took into account the possibility that sales would arise in earlier periods, and cannot demonstrate that such a development was unforeseeable."

Paragraph 20 clearly suggests that before the tax administration concludes under paragraph 6.192 that a transfer pricing adjustment is warranted, it used the presumptive evidence of the *ex-post* result to challenge the *ex-ante* valuation, but ultimately, because the taxpayer failed to demonstrate the reasonableness of the *ex-ante* valuation, the tax administration concluded from that failure that a transfer pricing adjustment is warranted.

The conclusion that a transfer pricing adjustment is warranted in this example is thus not inferred directly from the observation of daylight between *ex-post* outcome and *ex-ante* valuation.

This confirms our understanding that the assumption common to all examples that "a transfer pricing adjustment is warranted for the transaction" is meant to say that after considering the appropriateness of the *ex-ante* valuation through audit procedures, the conclusion reached by the tax administration is that a transfer pricing adjustment is warranted.

Because the example is silent as to what information about the *ex-ante* valuation is provided by the taxpayer, as to why the tax administration concluded that such information was not sufficient to trigger a paragraph 6.193(i) exception, and as to what information would have been satisfactory to a tax administration, the usefulness of the example is not in illustrating how the determination that a transfer pricing adjustment is warranted. Such illustration would be welcomed.

For example, suppose the hypothetical taxpayer has a history of development and commercialization of pharmaceutical compounds. Further suppose that in only 1 percent of prior development activities did commercial sales commence three years prior to *ex-ante* projections. As a result, assume the taxpayer applied a probability of 1 percent to this event in the subject transfer and associated financial projection.

Would the production of such evidence satisfy tax administrations? Would tax administrations not satisfied by the production of such information and proceeding with a transfer pricing adjustment concede that the adjustment is likely to be immaterial because even if the true unobservable *ex-ante* probability was not 1 percent but say 2 percent (a 100 percent adjustment to the probability), the probability-weighted average may not be that different:

- Because if you increase the *ex-ante* probability of some events, then you must reduce the probability of some other events. Therefore, even if the taxpayer underestimated the probability of much accelerated commercialization, what did she do with the probabilities assigned to "much delayed" commercialization? A taxpayer who did not incorporate in *ex-ante* projections the possibility of accelerated or delayed commercialization around the expected date of commercialization (year 6), effectively assigned a probability of one to commercialization in year 6. The *ex-post* evidence leading up to the tax administration's HTVI inquiry would then result in decreasing the probability of commercialization in year 6, increasing the probability of commercialization in years prior to year 6 (that increases the valuation), but also increase the probability of commercialization in years after year 6 (that decreases the valuation). It is unclear whether the net effect of these two elements of an appropriate HTVI adjustment should always be positive. Failure to decrease probabilities of events mutually exclusive (the non-*ex-post* outcomes) with the event that has received an upward adjustment to its probability (the *ex-post* outcome) would violate basic rules of probability theory; and

- A large adjustment to the probability of a very low probability event further subject to discounting when incorporated in a financial projection from an *ex-ante* point of view will be small, unless the cash flow to which the probability applies is extremely large.

Finally, paragraph 20 deals with the HTVI adjustment itself. The example specifically states that the adjustment of 300 in year 0 of the transfer is "not necessarily the net present value of the transferred rights based solely on the actual outcome."

This illustrates the statement at paragraph 6 we discussed in Part One, establishing that such an adjustment based solely on the actual outcome would not be arm's length, as it would imply that the HTVI is not an HTVI because the *ex-post* outcome would have to be assigned a probability of one (*i.e.*, "almost surely" or "surely") in the adjusted *ex-ante* financial projection. This clearly violates the paragraph 6.189 definition of an HTVI (in that respect). Therefore, we recommend eliminating the words "not necessarily" or at least eliminate those words and insert "it would be highly unusual for."

Again, the example is not useful in guiding tax administrations to translate the presumptive evidence of an *ex-post* result into an adjustment to the *ex-ante* financial projection through an adjustment on the probabilities used in the *ex-ante* valuation.

Similarly, the example is not useful in providing taxpayers with any information to quantify on an *ex-ante* basis, and on an *ex-post* basis, as the uncertainty associated with the HTVI transfer starts to resolve, the financial statement exposure of their uncertain HTVI valuation position. Such an addition would be very useful in assisting tax administrations and taxpayers in applying the rules.

Moreover, this example would be clarified if the OECD were to add to the narrative of the fact pattern that the year of commercialization was determined by the company's internal plan, and did not take into account industry averages or the fact that it may take less or more time to obtain approval to commercialize.

### Example 1 Scenario B

This example is similar to the previous one, with the exception that the adjustment is 100 instead of 300. Since 100 is within the 20 percent HTVI exception at paragraph 6.193(iii), the HTVI approach does not apply.

All of our comments in the discussion of the previous example are equally applicable and incorporated herein by reference.

Deloitte Tax has no further comments on this example, other than to recommend that it be kept, as it illustrates the application of the paragraph 6.193(iii) exception, which in and of itself is helpful.

### Example 2

Example 2 shares a lot of similarities with Example 1, Scenario A, and all of our comments in the discussion of the previous example are equally applicable and incorporated herein by reference.

The point of Example 2, however, is to illustrate the application of the guidance at paragraph 6.192 that authorizes the reliance on paragraph 6.185 to change a form of payment as part of an HTVI adjustment.

Paragraph 27 states that "However, the significant revision to the lump-sum payment highlights the risks posed by the high uncertainty in valuing the intangible and gives rise to consideration, in light of this significant uncertainty, of whether adjustments consistent with an alternative structure might protect against subsequent developments that are not sufficiently predictable (see 6.183 of Chapter VI of the Guidelines)."

Such consideration leads to a paragraph 28 conclusion that "The tax administration may, therefore, determine that it is consistent with the arm's length practices in comparable circumstances to recover the underpayment through a further lump-sum payment in Year 3." Such conclusion is arrived at because "…in the pharmaceutical sector it is common to transfer patent rights to independent parties through a combination of initial lump sum payments and additional contingent payment arrangements based on the successful completion of development phases or regulatory approvals in a particular market."

The guidance proceeds to make clear that it does not intend or imply that "modification of the form of payment form can only occur when there is a common practice in the relevant business sector regarding the form of payment for the transfer of a particular type of intangible."

In the section of Part One that discusses changes in form of payment, we clearly established that changing the form of payment in an otherwise accurately delineated transaction may or may not affect the allocation of risk between parties. Changing a form of payment from lump sum paid out in one year to paid out in multiple years through installments of the same present value has less impact on the allocation of risk than changing the form of payment from lump sum to contingent.

The guidance provided at Example 2 should therefore point that out. Practically, that means that the discount rate used in the adjusted *ex-ante* valuation may need to be adjusted as well *vis-à-vis* the discount rate used by the taxpayer in her *ex-ante* valuation, to produce a valuation consistent with the allocation of risk implied by the adjusted form of payment. *See* our numerical illustration of this point in Section One.

When the form of payment is changed from lump sum to contingent, even if only partially, the assumption of systemic risk of the parties to the transaction does change, and a corrective adjustment to the discount rate used by the taxpayer is warranted.[23]

### Example 3

Example 3 follows the same basic fact pattern as the previous examples, but concerns a taxpayer using a contingent form of payment rather than a year 0 lump sum. The purpose of this example is to illustrate how the guidance may interact with domestic law of each country and the rules on statutes of limitations applicable to these transactions.

All of our comments in the discussion of the previous examples are equally applicable and incorporated herein by reference.

We reiterate that reliance on domestic laws and the mutual agreement procedure to resolve HTVI disputes between tax administrations should be a last resort, because the elimination of double taxation will greatly depend on the countries on each side of the HTVI transfer. Whether the specific idiosyncrasies of the domestic laws of the jurisdictions involved will be conducive to the elimination of double taxation, and whether the jurisdictions involved have a treaty and have adopted the dispute resolution mechanisms best suited for the elimination of double taxation (*e.g.*, binding arbitration) can vary widely.

In connection with both Example 2 and Example 3, in order to provide HTVI implementation guidance respectful of domestic rules on statutes of limitations, and provide taxpayers with a greater ability to manage financial statement exposure, the OECD could consider providing guidance to the effect that if the statute of limitations has expired, then there should be no adjustment that incorporates earlier years, unless the result would leave a variance in payments in excess of 20 percent. This appears to be the only way to have the statute have some reasonable application.

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[23] We assume that the accurate delineation of the transaction confirmed the risk assumption implied by the lump-sum form of payment, and that the discount rate used by the taxpayer in the *ex-ante* HTVI valuation is consistent with such assumption of risk by each party. If this were not the case, we would not be addressing the HTVI framework, we would be addressing a non-HTVI-related issue of accurate delineation of the transaction under Chapter I and of application of the valuation guidance of Chapter VI Section D.2.6.3.

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30 juin 2017

By email

**Comments on Public Discussion Draft**
**BEPS Action 8: Implementation Guidance on Hard-to-Value Intangibles**

**Richard Newby & Andrew Cousins**[1]

We welcome the opportunity to comment on the public discussion draft ('DD') issued by the OECD on 23 May, 2017, with respect to the principles that should underpin the implementation of the hard-to-value intangibles ('HTVI') approach contained in Section D.4 of Chapter VI of the Transfer Pricing Guidelines ('TPG'), resulting from the BEPS 2015 Final Report for Actions 8-10, "Aligning Transfer Pricing Outcomes with Value Creation".

We would re-iterate our support for the treatment of HTVI implemented in Chapter VI and, in particular, the definition at 6.189 and the exemptions at 6.193, including the fundamental taxpayer right of rebuttable presumption in support of the pricing adopted at the time of the controlled transaction.

The BEPS 2015 Final Report stated that the Chapter VI exemptions will be reviewed against experience by 2020.

The DD is very brief and does not alter the HTVI approach provided in Section D.4.

Against this background, the DD seeks our views as the practical implementation aspects of Section D.4 of the TPG, in order to address what would constitute sufficient guidance to ensure that both tax administrations and taxpayers can agree on when the HTVI regime should apply, what principles should apply and how those principles should be applied.

## 1. Examples in the Discussion Draft

The DD provides 3 Examples, with 2 Scenarios being provided for Example 1.

These examples represent a helpful start but illustrate only one type of HTVI circumstance derived from the presumption that the exemptions identified in paragraph 6.193 do not apply.

[1] The opinions expressed in this paper are those of the authors and do not necessarily reflect the views of Duff & Phelps as a whole or those of its clients.

Further examples are therefore necessary adequately to illustrate the varied types of circumstances in which HTVI considerations arise. Under 'The Need for Further Examples' below we suggest the further types of examples to be developed.

## 2. The Need for Further Examples

Providing examples to illustrate paragraphs 6.189 and 6.190 of the TPG, and in particular to illustrate each manifestation of HTVI identified in paragraph 6.190, would provide further practical implementation guidance and would provide additional clarity to tax administrations and taxpayers alike. The current discussion draft takes, as a starting proposition, the assumption that the exemptions outlined in paragraph 6.193 do not apply. In so doing, the DD loses the opportunity to provide further clarifying examples of the practical implementation of HTVI.

*Unforeseeable Events*

It would be helpful to provide additional examples identifying the types of situations where events would reasonably be determined to be unforeseeable.

Real life provides a plethora of such examples, including many which have resulted in high-profile jurisprudence.

We therefore recommend that the OECD identifies real-life HTVI examples (or realistic proxies thereof) that can be developed into useful, illustrative examples.

For example, we would cite the United Kingdom's Brexit Referendum, the outcome of which was not reasonably foreseen pre-June 23, 2016, yet which led to a significant devaluation of Sterling and, subject to the specific facts and circumstances in any particular case, the consequent increase in the value of intangible assets previously transferred to the UK and licensed overseas from there.

Other types of examples might include, for instance, circumstances in which a competitor faces a supply problem that was reasonably unforeseen at the transaction date, leading to unexpected gains in market share, or where the cost of an input has been driven up by unanticipated shocks to input prices (by, for instance, atypical movements in commodity prices).

*Adequate Consideration of Foreseeable Events*

In addition to real-life examples to illustrate the application of Section D.4, equally valuable would be examples to illustrate where the *ex post* approach does not apply because the taxpayer gave adequate consideration to foreseeable events.

Since the *ex post* approach can be disregarded by the preparation of acceptable documentation at the time of the valuation, demonstrating that all reasonably foreseeable outcomes have been considered, illustrative examples are crucial to a proper understanding of the reasonable and practical parameters to applying this maxim.

It may be helpful to provide additional examples identifying the types of situations where events would reasonably be determined to be unforeseeable. To some extent, it may be possible to introduce helpful illustration of these types of considerations by expanding the examples already provided in the DD

For example, by being more explicit within Example 1 (scenario A) about what considerations might govern a finding that "*the taxpayer cannot demonstrate that its initial valuation took into account the possibility that sales would arise in earlier periods, and cannot demonstrate that such a development was unforeseeable*.", there may be additional scenarios that could be developed which would demonstrate the types of information that the taxpayer would need to be able to produce that might yield an adequate demonstration that appropriate consideration to foreseeable events may, in fact have been provided. There may also be certain characteristics or indicators that might govern judgments about the adequacy of considerations in the projections – some of which may already be discussed with section D.2.6.4 (where various concerns about inadequate projections are discussed).

Moreover, although the exemptions are valuable expressions of intent, without wide-ranging examples the instinct of some tax authorities may be simply to contend that because a post-transaction outcome exceeds the 20% materiality threshold, the underlying projections and assumptions at the time of the controlled transaction could not have been reasonable. This type of position might be buttressed by language similar to that highlighted above (i.e. "*the taxpayer cannot demonstrate that such a development was unforeseeable*", which seems to place an unreasonable burden of proof on taxpayers) with examples to help illustrate what it means to meet the intended (and reasonable) standard.

We believe that, in practice, this represents a very real risk and is therefore at the heart of the practical implementation comments sought by the DD.

Otherwise stated, we believe that further, detailed examples are required to demonstrate the facts and circumstances in which HTVI classification under 6.189 is not warranted, regardless of the *ex post* outcome.

In practical terms, therefore, we recommend the development of practical examples, illustrating what does and does not constitute:

- sufficient evidence to demonstrate the reasonableness of projections and assumptions;
- acceptable approaches to probability weighting, including the scenarios that need to be considered and given a probability weighting. For example, the DD examples identify earlier and higher sales than assumed, but are silent as to whether the probability weightings need to consider multiple scenarios such as earlier sales, predicted sales and later sales, or what combinations, and how many iterations of these, might be acceptable. Extremely useful practical examples in this respect would also extend to illustrating the acceptable bases for assigning probability, and the most acceptable data sources for those bases, including

references to the approaches adopted in third party circumstances, and generally in income based valuation techniques;
- a reasonably foreseeable event. We have already cited the Brexit example above, and there are many other examples that could usefully be drawn upon, disruptive technologies and breakthrough drugs being just two such.

### 3. HTVI and the Mutual Agreement Procedure

The DD points out *"…this guidance* [in 6.195] *should be read in conjunction with the framework of the commitment made in the Final BEPS Report for Action 14 'Making Dispute Resolution Mechanisms More Effective.' That Report describes the minimum standard on dispute resolution to which the G20/OECD countries have committed, which consists of specific measures to remove obstacles to an effective and efficient mutual agreement procedure."*

In the specific context of HTVI, it will be essential for MAP purposes that all parties – the tax administrations and the taxpayers alike - can agree on the most equitable basis of application.

In this respect, we would recommend that the OECD develops detailed guidance (including by way of the examples recommended above) of illustrative facts and circumstances to resolve situations in which one tax administration applies the *ex post* approach and another considers that it does not apply. Critically, in this respect will be the identification of situations in which it acceptable and unacceptable for one tax administration to seek HTVI reassessment when the taxpayer's position with respect to the HTVI in question has been agreed by the treaty partner tax administration for a period of time less than the 5-year commercialisation period at TPG 6.193 iv).

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In conclusion, we feel that the most valuable contribution to the practical implementation of HTVI would come from the development of detailed illustrative examples, as outlined above, covering reasonable facts and circumstances in which the *ex post* approach should not be applied by tax administrations.

We look forward to seeing the cumulative comments received on the Discussion Draft and the OECD's resulting further recommendations in due course.

Yours faithfully,

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Managing Director

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SUBJECT: COMMENTS ON PUBLIC DISCUSSION DRAFT ON *IMPLEMENTATION GUIDANCE ON HARD-TO-VALUE INTANGIBLES*

30 June 2017

Dear Sir / Madam,

By means of this letter, EY submits its comments on the public discussion draft on *Implementation Guidance on Hard-to-Value Intangibles* (the Discussion Draft), as released by the OECD on 23 May 2017. We appreciate the opportunity to provide comments and to contribute to the continued discussions about the transfer pricing aspects of hard-to-value intangibles (HTVIs). This letter presents the collective view of EY's global international tax network.

## General comments

This Discussion Draft presents the principles that should underlie the implementation of the HTVI approach. A number of examples have been included to clarify the implementation of the HTVI approach in different scenarios. The Final Reports on BEPS Actions 8-10 indicated that guidance on the implementation of this approach would be provided during 2016. The Discussion Draft at various places refers to implementation guidance for tax administrations. In our view, the guidance should be aimed at both tax administrations and taxpayers. The guidance on HTVIs that has been incorporated in the OECD Transfer Pricing Guidelines (TPG) as a result of BEPS Actions 8-10 leaves ample room for interpretation. We believe many of the areas that would deserve further implementation guidance have not been addressed in the Discussion Draft. Therefore, our comments will not only address what currently has been included in the Discussion Draft, but also what we believe should be included.

The guidance on HTVIs is aimed at protecting tax administrations from the negative effects of information asymmetry. However, we believe that the current (implementation) guidance in our view does not lead to a situation in which this is achieved in a balanced manner, but instead creates a significant burden and significant disadvantages for taxpayers even in cases which will not be perceived as base erosion or profit shifting cases, e.g., because it concerns a transaction involving countries with similar tax rates. Therefore, we believe that additional guidance (i.e., more than currently provided in the Discussion Draft) is required to ensure that, in practice, the approach on HTVI does not create disproportionate and unrealistic burdens for taxpayers.

In this regard, we think it is important to consider that taxpayers are compelled by the arm's length standard to value transactions (including those involving HTVIs) based on an *ex ante* standard. Consequently, when taxpayers value HTVIs using a discounted cash flow (DCF) method that makes use of projections, it is entirely possible for the projections to turn out to be incorrect. The HTVIs might either underperform or outperform projections. Neither establishes that projections were not done in good faith or were not the most reliable that the taxpayer could have created at the time of the transaction.

The HTVI approach creates a significant burden for taxpayers and it is not clear what taxpayers are supposed to demonstrate or prove in order to meet their burden. Since the arm's length pricing is an *ex ante* system, taxpayers should, in our view, not be required to show more than that the projections were reasonable at the time of the transaction. This could be demonstrated, for example, by evidence that projections were used for non-tax purposes (e.g., for making business decisions). Taxpayers should also not be forced to model all possible scenarios and all probabilities. We suggest that the OECD provide additional clarifications and more detailed guidance on this matter.

In addition, we recommend that some relief be provided to taxpayers once it is has been established that the HTVI approach does not apply. For example, no adjustments should be made if the difference between the price applied and the compensation reconstructed based on *ex post* outcomes is less than 20%. Furthermore, we recommend that it be clarified that the onus is on the tax administration if they propose to deviate from pricing arrangements made by the taxpayer, in cases where the approach on HTVIs does not apply (e.g., in cases covered by the guidance in section D.3 of Chapter VI of the TPG). In general, the TPG do not address the burden of proof. If the OECD would nevertheless decide to keep the guidance that adjustments based on the general guidance should be possible even if the taxpayer can demonstrate that the exceptions apply, we believe the TPG should at least include that the burden of proof is on the tax administration. In this regard, we also suggest that a more explicit distinction is made between an interpretation of the arm's length principle and a burden of proof or proxy rule such as the one for HTVIs. An interpretation of the arm's length principle can in our view only provide the technical steps to determine an arm's length price, whereas a burden of proof rule chooses a certain price, which may or may not be an arm's length price, as a proxy and asks the taxpayer to rebut if the "real" arm's length price in the specific set of circumstances deviates from this proxy. Such a burden of proof rule cannot be seen as an interpretation of the arm's length principle.

In general, we recommend that the OECD provide clarification on the topic of the effective date of new transfer pricing guidance. Given the importance of this specific topic, we strongly believe guidance on the effective date is justified.

The Discussion Draft does not reference a public consultation. Given the importance of the topic, we recommend that such consultation be held to discuss the comments received.

More detailed comments with respect to the Discussion Draft are presented below. If you have any comments or questions, please feel free to contact any of the following:


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Yours Sincerely,
*On behalf of EY*

Ronald van den Brekel

## Detailed comments

Our detailed comments with respect to the Discussion Draft are presented below.

### Definition of HTVI

The definition of an HTVI is provided in paragraph 6.189 of the TPG. This is followed by a list of some "features" that a transaction involving an HTVI may show, in paragraph 6.190. To clarify, we recommend that it be explicitly stated that a transaction that shows some of the features mentioned in paragraph 6.190 is not automatically a transaction involving an HTVI and that the intangible involved, as such, should meet the requirements as mentioned in paragraph 6.189. If, for example, a partly developed intangible is transferred between related parties in exchange for a lump sum payment, tax administrations should still be able to demonstrate that both requirements[1] of paragraph 6.189 are met. With respect to the question whether reliable comparables exist: it might be the case that independent transactions with a similar structure or characteristics exist, which cannot be used as comparables since they do not fulfill all the comparability factors needed to <u>price</u> a transaction. The structure or the characteristics could, however, demonstrate that in broadly similar transactions, third parties do not apply a mechanism to address high uncertainty as described in paragraph 6.185. Such evidence should not be rejected merely because the information cannot be used as comparables information to price the transaction.

### When the approach on HTVI *does not* apply

We understand that when the HTVI approach does *not* apply, e.g., because the intangible in the case at hand does not meet the definition as per paragraph 6.189, other sections of the TPG may still apply. This is mentioned explicitly in paragraph 23 of the Discussion Draft. If in such cases disputes will arise with respect to the arm's length nature of the pricing arrangements agreed upon by the taxpayer (e.g., the absence of price adjustment clauses, or the lack of contingency payments), we believe that it would be fair to place the burden of proof on the tax administration if they wish to deviate from the conditions agreed upon by the taxpayer, especially taking into account the severe burden of proof that is placed on the taxpayers if the HTVI approach *does* apply.

### When the approach on HTVI *does* apply

Valuation of HTVI when the approach as described in section D.4 of the TPG applies, seems unrelated to evaluating whether the taxpayer's *ex ante* valuation was reasonable and instead is a purely asymmetric system that allows tax administrations to increase the tax burden but never allows taxpayers to reduce their tax burden. This is demonstrated in examples 1 and 2. It could well be that the value of 700 was a "best estimate" and the taxpayer concluded that the best way of dealing with variance in possible outcomes was to discount income streams to present value using a risk-adjusted discount rate. The mere fact that taxpayer did not specifically model the results for all possible outcomes does not establish the taxpayer was unreasonable. The Discussion Draft seems to imply that all possible scenarios should have been modelled by the taxpayer. We believe that a taxpayer should not be required to do so.

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1 This concerns i) the "lack of comparability data" and ii) the "highly uncertain cash flows or income" tests.

### Exceptions

The first exception as per paragraph 6.193, in essence, requires taxpayers to demonstrate the reasonability of the *ex ante* projections *and* to provide reliable evidence that any significant difference between the projections and actual outcomes is due to unforeseeable developments. While we understand the rationale behind this, we note that in many instances it will be very difficult (or impossible) to demonstrate which specific developments caused the difference between projections and actual outcomes and what the impact of each specific development was. In addition, it may be very difficult or even impossible to demonstrate that the probabilities of occurrence of foreseeable outcomes were not significantly overestimated or underestimated at the time of the transaction. This means that in many cases taxpayers are confronted with an impossible burden of proof resulting in a *de facto* obligation to include a price adjustment clause or contingency payments in transactions involving HTVIs.

In our view, the burden of proof in principle should be on tax administrations in cases where they wish to apply pricing arrangements that differ from those actually agreed upon by the taxpayer. However, if by fiction such a clause is considered to be arm's length (as the HTVI approach effectively does), we consider it fair that the HTVI approach is not applicable if the taxpayer can reasonably demonstrate that independent parties in broadly similar circumstances would have been willing to enter into a transaction involving an HTVI without a price adjustment clause or a price adjustment clause with a limited scope. We recommend the OECD clarify that there will still be the option for the taxpayer to provide such information and arguments, in addition to the exceptions as per paragraph 6.193. Since in these cases there will inherently be no comparable uncontrolled transactions, we believe taxpayers should be allowed to provide broad comparables or other information to demonstrate this.

The third exception as per paragraph 6.193 states that the HTVI approach does not apply if any significant difference between the financial projections and actual outcomes does not have the effect of reducing or increasing the compensation for the HTVI by more than 20% of the compensation determined at the time of the transaction. The Discussion Draft mentions that it would be incorrect to base the revised valuation on the actual income or cash flows without also taking into account the probability, at the time of the transaction, of the income or cash flows being achieved. While we fully agree with this statement, we expect that significant discussions can arise in this regard, e.g., because of disagreement about the "weighing" of the various possible outcomes based on their probability of occurrence. The Discussion Draft provides no guidance on how to practically address this and we recommend that guidance on this matter is provided.

### No adjustment if exception applies

We note that the Discussion Draft in paragraph 23 mentions that even when one of the exceptions of paragraph 6.193 applies, "an adjustment under other sections of these Guidelines may be appropriate". While we are not sure whether the OECD has any particular guidance in mind in this statement, we would expect that in these instances (i.e., when one of the exceptions as per paragraph 6.193 applies) tax administrations would not be able to scrutinize the payment arrangements agreed upon by the taxpayer and that no transfer pricing adjustments would be made in respect of differences between projections used and actual outcomes at a later stage. For example, tax administrations should in these instances not be allowed to argue that a price adjustment clause should be put in place. If the OECD nevertheless would decide to maintain the guidance as currently included. We believe it should be made explicit that in such cases the burden of proof is on the tax administration.

Making the adjustment

If the approach on HTVI applies and the taxpayer is not able to demonstrate that one of the exceptions applies, the question arises on how the transfer pricing adjustment can be given effect. Paragraph 28 includes an example of a sector in which *"it is common to transfer patent rights to independent parties through a combination of initial lump sum payments and additional contingent payment arrangements"*. In that example, the tax administration is allowed to "recover the underpayment through a further lump sum-payment in Year 3." We assume the OECD is of the view that such an adjustment in Year 3 can only be made if an adjustment in the first year would also be possible taking into account the applicable statutes of limitation. Effectively the adjustment is a result of a condition of a transaction in year 0 that apparently was not at arm's length. To ensure that the HTVI approach does not effectively overrule statute of limitations rules, we recommend a more explicit statement from the OECD on this matter.

Paragraph 28 states that *"The tax administration may, therefore, determine that it is consistent with arm's length practices in comparable circumstances to recover the underpayment through a further lump sum payment in Year 3."* It is not entirely clear what is meant by "may determine". This could be read as it being at the discretion of the tax administration to *assume* it is at arm's length to have a further lump sum payment. This is even strengthened by the rest of the paragraph that states *"is not intended to [...] imply that modification of the payment form can only occur when there is a common practice in the relevant business sector regarding the form of payment for the transfer of a particular type of intangible"*. We believe that a tax administration should not be allowed to simply *assume* any form of payment or deem a pricing arrangement without further substantiation. Tax administrations should only be allowed to apply arm's length conditions, and they should demonstrate the arm's length nature of the alternative pricing arrangements if they deviate from the contractual arrangements, even if the HTVI approach applies.

Effective date

The Discussion Draft is silent on the effective date of the (new) HTVI approach as introduced in the final report on Actions 8-10 in October 2015. Taking into account the far-reaching consequences of the approach, we believe that this guidance can only apply to transactions involving HTVI that occur after the introduction of the new rules, either being October 2015 (the date of publication of the final report) or May 2016 (the date of the OECD council recommendation), or even after the inclusion of the guidance in the domestic law of specific countries. We recommend that the OECD provide clarification on the effective date of the guidance.

Double taxation

We realize that the Discussion Draft should be read in conjunction with the framework of the commitment made in the BEPS Action 14 final report. We are concerned, however, that this may provide limited protection against double taxation because the HTVI approach relies heavily on the shift of the burden of proof to the taxpayer. Convincing a competent authority to accept a corresponding adjustment may be particularly difficult if the primary adjustment of the transaction is based primarily or merely on the "presumptive evidence" in the form of *ex post* outcomes, and not based on a detailed and thorough analysis from the side of the tax administration that proposes the primary adjustment. We recommend introducing further safeguards to ensure that double-taxation can effectively be avoided. This is particularly important because the guidance applies also to cases that are not perceived as base erosion and profit shifting cases.

## Closing remarks

We hope tax administrations realize the uncertainty the approach on HTVI poses on the taxpayer. Therefore, it would be good if a “best practice” would be identified through which the taxpayer can get assurance of the tax administration(s) involved that the price set at the time of the transfer meets the guarantees required in the HTVI guidance and that therefore no post transfer adjustments are required. We realize that the guidance on HTVI is aimed at protecting tax administrations from the negative effects of information asymmetry by using *ex post* outcomes as presumptive evidence about the appropriateness of the *ex-ante* pricing arrangements. However, the draft guidance seems more focused on the potential risks of underestimating HTVI (e.g., potential “profit shifting”), but not the other way around. Examples in the draft guidelines illustrate HTVI underestimation cases only. From a technical perspective, additional guidance and examples should be provided to establish a more objective and balanced guideline.

We recommend that a public consultation be held to further discuss the implementation aspects of the guidance on HTVI, such as the ones described in the Discussion Draft, and those mentioned in this letter.

*****

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June 26, 2017

**Tax Treaties, Transfer Pricing and Financial Transactions Division**

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**Sent by email: TransferPricing@oecd.org**

**REF: PUBLIC DISCUSSION DRAFT - BEPS Action 8 Implementation Guidance on Hard-to-Value Intangibles**

Dear Sirs,

We are pleased to have the opportunity to submit our comments on the subject matter. An ambiguous approach to the valuation of Hard to Value Intangible ("*HTVI*") may cause double taxation issues by also potentially further increasing the level of complexity that underlines the difficulty of Working Party to reach consensus on the matters arising from intragroup intangibles transfers.

The essence of the problem is if the *ex post* approach could *ex se* constitute *sufficient* conditions to restate the price settled *ex ante* between the parties. The TP Guidelines suggest avoiding the use of hindsight to deny related-party deals, especially when tax authorities evaluate the pricing of a controlled transaction involving intangible property where valuation is highly uncertain from the outset. In such a case, tax authorities could evaluate, for example, whether the related parties have made adequate projections, taking into account all the circumstances that were reasonably foreseeable, without using hindsight.

We welcome that any adjustments should be limited to cases in which actual profitability deviates by more than 20 per cent. However, we maintain that these safeguards are not sufficient to solve the problems arising from the HTVI valuation. Falling outside this threshold exposes taxpayers to a high risk of uncertainty because the *ex post* outcomes are based on actual results whereas *ex ante* approaches are based on forecasts. The lack of a "list" of unforeseeable and extraordinary events outside the control of the taxpayer, make the whole picture even more uncertain.

The envisaged situation generated is one of *probatio diabolica* towards the taxpayer, who will be forced to rebut presumptive evidence by demonstrating the reliability of the information available at the time the controlled transaction took place.

Tax authorities may argue that the low probability of one event occurring does not exclude 100% the fact that it could arise; such a wider spectrum of probability makes it easier for tax authorities to maintain that the event was known and could have been anticipated at the time of entering into the transaction involving the HTVI. Taxpayers may be affected by the *ex post* windfall result used by tax authorities as a starting point for price adjustments, rather than by the windfall outcome. This gives rise to additional concerns as the windfall result (i.e., the price adjustment) might be (highly) influenced by fluctuations of cash flows not adequately accounted for by tax authorities, multiple-year analyses, changing certain variables in sensitivity analysis or assigning alternative probability distributions to key assumptions.

As a rule, third parties do agree prices in advance. This circumstance, however, does not hamper the provision of price adjustment mechanisms to reflect unexpected circumstances or any further element that might significantly affect the cost and return respectively on the transaction. It is better to be safe than sorry. For this purpose, we believe that it could be useful to include some guidance in the Draft on how these adjustments should take place in different scenarios, expanding the example provided with the inclusion of more complex situations (e.g. HTVI portfolio, implementation of HTVI in product/service becomes *impossible*, costs of R&D becomes *prohibitively* high, etc.), as in the real world taxpayers are affected by multifaceted conditions rather than simple straightforward ones.

This additional envisaged guidance might protect taxpayers from the negative effect of an adjustment by tax authorities with the adverse impact arising from a penalty application or, in an even more detrimental way, the restructuring of payment terms. In fact, among the tools provided to overcome any information asymmetry, the Guidance clearly states that the revised value may be assessed taking into account contingent payments, price adjustment clauses and/or alternative pricing structures that can be found in market transactions. In our view, care must be taken in the analysis and selection of transactions (and the relevant structures) performed by third parties as

- They might be affected by exogenous factors or other events that are not under the control of the parties; and
- Deals between independent parties might (sometimes) lead to *bad deals* due to the RAO (Realistically Available Options) standard, the bargaining power of the parties and other circumstances affecting their behaviour.

With reference to contingent payments, we notice that these types of payments (e.g., earn-outs) are very frequent in M&A transactions (especially in “megadeals”) as they allow the information asymmetries faced by small acquirers in valuation-complex deals to be addressed. In the context of HTVI, we believe that the use of contingent payments, from a practical standpoint, poses the following issues:

- Tax authorities should prove that in the market/industry under analysis contingent payments are at arm’s length
- The consistency and appropriateness of the model (i.e., multiple-scenario or the real option pricing) followed by the tax administration in a specific case
- The accurate qualification and quantification of the risks related to contingent considerations, with particular reference to the functions related to the development, enhancement, maintenance, protection and exploitation (DEMPE) of intangibles performed after the transfer of an HTVI.

Based on the above, we are concerned about the effective application of contingent payments to HTVI transactions due to the difficulties reported by practitioners in applying the aforementioned models, and namely:

- In a multiple-scenario model:
    - The estimation of the expected possible distribution of earn out cash flow at the measurement date and probability associated with each projection/forecast
    - The appropriate discount rate to be used in each projection/forecast
    - Management of potential variability in the selected metric(s) (e.g., R&D stages, clinical trials, specific project/product approval)
- In real option-pricing model:
    - (Partial) inconsistency of the outcomes
    - Management of potential variability in the selected metric(s).

With respect to price adjustment clauses, we are uncertain as to whether tax administrations are experienced in managing the issues posed by price adjustment clauses. We are aware of the use of price adjustments (especially in share deals) and wonder if they are *actually* widespread in dealings between independent parties and can serve as an effective tool to assess the *ex post* outcome of HTVI transactions.

Because of the variety of scenarios that might arise, considering the information asymmetry between the (extensive) information available to the taxpayer and the lack of information available to the tax administration, we believe that a unitary approach by all Countries would be helpful to solve the thorny issue related to the utilization of *ex post* financial results as the basis to calculate a transfer pricing adjustment on an *ex ante* price.

For this purpose, some guidance is needed on how to address the *unforeseeable/*the *unforeseen*/the *highly unlikely* in HTVI transactions. Concerns have arisen because in commercial litigation, courts are split on the question of whether a specific event can be unforeseeable from a legal perspective. Indeed distinguishing between foreseeable and unforeseeable events implies really distinguishing the likelihood and type of the event and, sometimes, this likelihood is in the eye of the analyst (i.e. it implies a *subjective* judgement of the parties involved).

In all the three examples provided, the Guidance states that the taxpayer "(…) **cannot**[1] demonstrate that its original valuation properly took into account the **possibility**[2] that sales would arise in earlier periods, and **cannot** demonstrate that such a development was unforeseeable". The Guidance does not provide any additional criteria that allow the readers/practitioners to understand the use of negation (**cannot)**. It is doubtful if the negation (**cannot)** is related to a mere lack of documentation, but to other factors not clearly stated in the Guidance that do not allow the user to take into consideration the reasoning underlying the *ex post* adjustments.

We suggest examining the matter related to the appropriate supporting documentation for HTVI purposes, as the (current) regulatory environment on TP documentation seems unable to address and provide a framework to manage the issues/features posed by the valuation/transfer of HTVI. A more detailed guidance would be consistent with Action 8 of the BEPS Action Plan, which mandated, *inter alia*, for the development/setting up of *special measures* for transfers of HTVI and these *special measures* may include *ad hoc* rules for documentation purposes. In this regard, we hold the view that (sound) documentation should follow the standard set by the IVSC and should include, at least, the following information:

- Specification of the basis of the valuation, including type and definition of value
- Specification of all assumptions and limiting conditions upon which the value conclusion is contingent
- Identify special, unusual, or extraordinary assumptions and address the probability that such conditions will occur
- Include a description of the information and data examined, the market analysis performed, the valuation approaches and procedures followed, and the reasoning that supports the analyses, opinions, and conclusions in the report.

We wonder if consensus may be reached by a standard approach that would entitle tax authorities to challenge the amount of HTVI only in exceptional scenarios, whereby, for example, the *ex ante* valuation as outlined in the MNE's transfer pricing reports and implemented in the agreements is totally contradicted by the *ex post* outcomes, for reasons that are not dependent on unforeseeable and/or extraordinary events.

[1] Bold added.

[2] Bold added.

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We remain at your disposal should you wish to discuss the issues we have raised in this paper in more detail. Please contact Diletta Fuxa (diletta.fuxa@fieldfisher.com) or Daniele Sabatini (daniele.sabatini@fieldfisher.com) for any additional information.

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30 June 2017
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2015142_v1

**Comments on the discussion draft on the implementation guidance on hard-to-value intangibles**

Dear Sir or Madame,

First of all, we would like to thank you for providing the opportunity to comment on the discussion draft on implementation guidance on hard-to-value intangibles (the "Discussion Draft"). From our point of view, subjecting your proposals to public scrutiny constitutes an indispensable aspect of building and maintaining credibility with taxpayers and tax administrations.

Having said that, we would like you to consider the following comments as constructive criticism aimed at achieving better and generally accepted Transfer Pricing Guidelines. Although they refer specifically to the Discussion Draft, they also apply to Section D.4 of the Revised Chapter VI of the Transfer Pricing Guidelines in general.

## I. Risk of using ex-post information for determining transfer prices

The OECD guidance on hard-to-value intangibles ("HTVI") aims to protect tax administrations from the negative effects of information asymmetry. Following this objective, the Discussion Draft states that tax administrations can consider ex-post outcomes as rebuttable presumptive evidence about the appropriateness of the ex-ante pricing arrangements related to transfers of HTVIs. At the same time, ex-post evidence should not be used without considering whether the information on which the ex-post results are based could or should reasonably have been considered at the time of entering into the transaction. This implies that tax administrations must not simply derive "correct" transfer prices from ex-post outcomes but may cautiously consider

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such information as rebuttable presumptive evidence on the appropriateness of ex-ante price setting. In considering such ex-post outcomes, the probabilities at the time of the transaction should be taken into account.

We agree that valuing intangibles is a matter of considerable uncertainty that requires making various assumptions. With the benefit of hindsight, some of these assumptions will prove to have been wrong or misguided. However, this hindsight does not imply that at the time the transaction was entered into making these assumptions was imprudent or unjustified and/or constituted a breach of the arm's length principle. Consequently, it does not necessarily require transfer prices to be adjusted. What would necessitate a transfer pricing adjustment is if the taxpayer had knowingly and demonstrably made wrong assumptions on which the valuation of an intangible was based. Ex-post outcomes may of course provide some evidence of such behavior. But, this is by no means conclusive. We would like to encourage the OECD to emphasize this with regard to HTVIs in the Discussion Draft. Moreover, the Discussion Draft states that tax administrations may make appropriate adjustments, including those that reflect an alternative pricing structure that is different from the structure adopted by the taxpayer. Yet, it does not indicate possible approaches for how to make such adjustments.

## II. Uncertain use and potential risks of the examples provided

We welcome illustrations of how the recommendations apply to transfers of HTVIs. Given that the questions at hand are very complex, we believe that examples may help your readers to better understand the OECD Transfer Pricing Guidelines and apply them to real-world cases.

From our point of view, the examples fail to illustrate what they would be needed for most, i.e. having found ex-post outcomes to evidence inappropriate transfer prices, how to reassess the taxpayer's decisions in weighting probabilities and pricing HTVIs at the time of the transaction. For instance, Example 1 Scenario A states that "the tax administration finds that the possibility of earlier sales should have been taken into account". However, how this insight is gained and how the probability (or possibility) of earlier sales may possibly be gauged from an ex-post perspective remains entirely unresolved.

In Example 2, sales turn out to be much higher than originally projected (1,500 versus 1,000). This is taken as presumptive evidence and, ultimately, the cause of a transfer pricing adjustment because the taxpayer cannot demonstrate that he has taken that eventuality into account. Yet, it does not sound unreasonable if – at the time the transaction took place – sales of 1,500 (i.e. 50% above the best-case scenario) were discarded for being improbable. While with the benefit of hindsight this assumption turns out to have been wrong, this does not necessarily warrant a transfer pricing adjustment.

Furthermore, all of the examples presented relate to transfers of HTVIs in the pharmaceutical industry. This could be interpreted as limiting the implementation guidance to transfers of HTVIs in that sector.

## III. Avoidance and resolution of double taxation

We would like the OECD to explicitly encourage tax administrations to accept transfer price adjustments both ways and from both perspectives (i.e. the transferor and the transferee in case of transfers of HTVIs). Thus, if certain indicators warrant an upwards adjustment of transfer prices, the same indicators (in reverse) must also trigger downwards adjustments. Moreover, tax administrations must not only push for upwards adjustments in transferors' cases but must also accept such adjustments in transferees' cases (e.g. with regard to a higher base for amortization). In this vein, the OECD should stress that any adjustments must not result in double taxation at the taxpayer's expense.

The Discussion Draft's guidance on access to MAPs is limited to a brief reference to BEPS Action 14 in order to resolve cases of double taxation arising from the application of the approach for HTVIs. Additional guidance on access to MAPs in such cases and the issue of the elapsed time between the transfer of HTVIs and the emergence of ex-post outcomes would be welcomed.

## IV. Further clarifications needed

While presumably not strictly within the scope of the Discussion Draft on implementation guidance, we would like to suggest adding the following clarifications:

The OECD guidance on HTVIs rightly assumes that there are information asymmetries between taxpayer and tax administration. This does not mean, however, that the taxpayer will possess any information needed for valuing an intangible. There are also uncertainties from the taxpayer's point of view. Though, the OECD seems to suggest that the consequence of any such uncertainty will ultimately be borne by the taxpayer. In other words: There are considerable legal uncertainties (i.e. whether and to what extent adjustments might take place) at the expense of the taxpayer. We would like to encourage the OECD to issue a clearly phrased safe-haven recommendation which allows taxpayers to structure a transaction involving HTVIs in a way that makes related tax payments predictable.

We hope that these brief remarks will contribute to the further discussion of the topic.

Yours sincerely,

Dr. Xaver Ditz Dr. Sven-Eric Bärsch Dr. Christian Engelen

**Organisation for Economic Co-operation and Development**

By email: TransferPricing@oecd.org

03 July 2017

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Dear Sirs,

**Response from FTI Consulting to the Public Discussion Draft - BEPS Action 8 Implementation Guidance on Hard-to-Value Intangibles**

We welcome this opportunity to comment on the Public Discussion Draft - BEPS Action 8 Implementation Guidance on Hard-to-Value Intangibles ("the Discussion Draft").

We agree to have our comments posted publicly.

We would like to thank you for the opportunity to comment on the Discussion Draft and hope our comments are helpful.

Yours sincerely,

Ruth Steedman
Enc.

## Introduction

The purpose of the Discussion Draft is to present the principles that should underlie the implementation of the approach to hard-to-value intangibles ("HTVI"), provide examples illustrating the application of this approach, and address the interaction between the approach to HTVIs and the mutual agreement procedure under an applicable treaty.

The additional guidance from the OECD is welcomed and helpful in addressing the application of the HTVI approach. We have identified a key area where it is thought that the guidance could benefit from amplification.

## Appropriate reflection of the complexity involved

Whilst the guidance provided in the Discussion Draft is useful, it appears to limit itself in its effectiveness because it provides somewhat oversimplified examples and scenarios in an area which is considered to be highly complex. The HTVI approach requires in-depth analysis often requiring extensive research into the facts and circumstances of the taxpayer at the point of valuation.

It is our view that the assumptions made by the taxpayer in deriving a value for the transfer of an intangible (based on methods such as discounted cash flow analysis) is where much of the complexity lies in the approach to HTVI. We believe that the most significant area of contention between the taxpayer and tax authority will arise out of these assumptions being challenged or adjusted by the tax authority based on the use of *ex post* information. As such, we would suggest expanding the guidance to include a detailed example(s) of how a tax authority would assess each assumption made by the taxpayer in arriving at a transfer value and the considerations required by the tax authority in assessing each of those assumptions. Such examples would provide guidance to tax authorities in determining which situations the pricing arrangements as determined by the taxpayers are at arm's length and which merit adjustment in the light of *ex post* outcomes. Furthermore, it is important that tax authorities are able to appreciate the level of effort and analysis needed to determine whether a taxpayer has made sound and credible assumptions based on the facts, circumstances and information available at the time in determining a transfer value.

Further, it may be helpful to include guidance as to how taxpayers may best provide supporting documentation evidencing the steps taken to arrive at their valuation. This will assist both taxpayers and tax authorities alike in understanding the type and depth of evidence required to rebut the use of *ex post* outcomes.

Finally, if the guidance discussed above is provided before the current examples, this will assist in illustrating the complexities involved and the attention required first to the question of whether it is appropriate to use *ex post* outcomes before moving on to how *ex post* outcomes result in adjustments, as illustrated in the examples currently provided.

**Conclusion**

In conclusion, the additional guidance is both welcomed and helpful. We would however like to see the Discussion Draft expanded to include detailed examples of the assessment of a taxpayer's assumptions and methodology employed for HTVIs by a tax authority. We believe this will make the level of complexity involved in determining arm's length pricing for HTVIs clearer and provide for an appropriate starting point for dialogue between tax payers and tax authorities.

We look forward to the opportunity to continue to provide input on these important issues. Thank you again for the opportunity to share our ideas and concerns.

HCAT nsulting & Tax Ltd
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June 30, 2017
To:
Tax Treaties,
Transfer Pricing and Financial Transactions Division,
OECD/CTPA
TransferPricing@oecd.org

**Re: BEP Action 8 discussion draft on the implementation guidance on hard-to-value intangibles -Discussion Draft May 23-June 30**

We respectfully present our comments on the above Discussion Draft. We are an accountancy firm keen to see reasonable tax paid without harming bona fide businesses.

**OECD Proposals in a Nutshell:**

According to the October 2015 Action 8 guidance, the term hard-to-value intangibles (HTVI) covers intangible assets or rights in intangibles for which, at the time of their transfer between associated companies, (i) no reliable comparables exist, and (ii) at the time the transaction was entered into, the 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. For example, the intangible may be only partially developed at the time of the transfer.

In such circumstances, the OECD says a tax administration can consider *ex post* outcomes as presumptive evidence about the appropriateness of the *ex ante* pricing arrangements, i.e. use hindsight.

However, the OECD disallows hindsight taxation where an exception applies, such as where the taxpayer uses detailed risk-based ex ante projections which prove to be at least 80% accurate (20% variance) by reference to subsequent actual revenues or compensation (e.g. the above $1000 royalties); or if a tax ruling is obtained.

The new draft emphasize that the "***probability-weighting***" (by the taxpayer) of such an outcome requires scrutiny, taking into account what was known and could have been anticipated at the time of entering into the HTVI transaction.

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**Our Comments:**

1. **Greater Tolerance:**
We believe the resulting methodology is still subjective and heavily tilted in the tax authorities' favor. Greater clarity and tolerance levels are needed e.g. a median probability weighted mis-forecast of 50% rather than 20%.

2. **Good faith:**
Alternatively to the above, we believe a good faith requirement would be sufficient.

3. **Unrelated Parties:**
Technology is often it is the result of a collaborative deal involving parties in many countries.. Unfortunately, the OECD May 2017 draft does not make an exception for collaborative deals. We recommend there be an exception for collaborative deals between **unrelated parties**. If this is already the OECD's intention, it should be emphasized.

4. **Non-Reliance on Dispute Procedures:**
The May 2017 draft does contain a solution of sorts - apply the mutual agreement procedure in an applicable tax treaty. But there this is a bureaucratic procedure, which can take years and still not yield a certain outcome, assuming a tax treaty with a mutual agreement procedure exists in a particular case. We recommend this be dropped as a solution.

* * * * * *

We will be happy to answer any questions arising.

Yours Truly

Leon Harris, CPA (Israel), FCA(UK)

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## ICC Comments on BEPS Action 8 Implementation Guidance on Hard-to-Value Intangibles (Public Discussion Draft)

ICC appreciates the opportunity to comment on the Implementation Guidance on Hard-to-Value Intangibles Discussion Draft. Hard-to-Value Intangibles (HTVI) are a frequent source of international tax disputes, leading to double taxation. This situation is especially worrisome as HTVI are a core feature of the digital economy. ICC therefore welcomes the OECD initiative to provide for an international standard.

ICC acknowledges the aim of the Discussion Draft in seeking to protect tax authorities in the event that they may be risk assessing and auditing transfers of HTVIs where currently the information provided may be insufficient to make an informed assessment. In addition, the guidance clearly increases the probability that tax payers would furnish greater levels of information to tax authorities.

ICC also acknowledges that the guidance is likely to encourage tax payers to ensure that before entering into pricing arrangements, they would consider alternative pricing arrangements (e.g. contingent payments, milestone payments, price adjustment clauses) which may lead to more accurate pricing models in certain circumstances.

The Discussion Draft describes a method in which tax administrations would be able to consider ex post outcomes as presumptive evidence regarding the appropriateness of the ex-ante pricing arrangements. This would enable tax authorities to use the ex post outcomes to revise the original transfer value of the HTVI several years after the transfer has taken place. In such cases, ICC is concerned that this adjustment may lead to double taxation and more tax disputes.

Furthermore, the proposed guidance on HTVI aims at making sure that the impact of an unexpected event can be corrected ex post so that the outcome of a transaction is always equitable. This search for ex post equity is not only subjective but can have potentially negative effects. It departs from the comparison with free market terms, as when independent third parties contract together, there is no guarantee that the deal will result equitably for them. Removing that risk from HTVI transactions would apply a different standard to intercompany transactions than to independent ones. In effect, this moves from the transfer pricing standard of arm's length to "international tax equity". It is essential for the international business community that the arm's length standard remains the backbone of transfer pricing guidance for a balanced international tax system[1].

In addition, a shift from "market price" to "equitable outcome" will reduce legal certainty for tax payers, as the notion of equity cannot be precisely defined. By enabling the tax authorities to wait until ex post outcomes are available, the taxpayer may be at a disadvantage, given that there would be no certainty on the future sales figures or profitability of a given product.

This would also create a system whereby international investors would only secure certainty regarding a tax liability years after the transactions have occurred. While the guidance aims to protect tax authorities, presumably there is no recourse for the taxpayers should the transfer price actually be too high once ex post outcomes are considered. Due to local statutory time limits, and the inability in certain territories to make downwards transfer pricing adjustments, it is unlikely that a feasible recourse would be available to taxpayers.

In many cases, the effective profit generated by an HTVI differs from the expectations of the parties reflected in their commercial agreement, without any renegotiation or restatement of the initial equilibrium being provided for. Therefore, the belief that an ex-post analysis is necessary to bring the tax position into line with the commercial reality is debatable.

Different HTVI business stages and valuation methods can have a significant impact on HTVI valuation. As such, ICC would like to signal the benefit of establishing empirical and reasonable

[1] HTVI should be tested only at the time of the transaction, based on a reasonably expected outcome.

valuation methods for tax administrations to adopt, to ensure the recommended method remains reasonable and consistent. For example, it may recommend the use of more than one valuation method to verify the reasonableness of an outcome, as opposed to using a single method.

Moreover, ICC is concerned with the proposal related to the burden of proof. It is our understanding from the Draft that taxpayers will need to demonstrate that all potential outcomes of the HTVI have been considered in the initial transactions.[2] From a general stand point, it is a common approach under transfer pricing rules to gather information and prepare contemporaneous documentation to sustain the choice of the taxpayer. ICC believes that the same rule should apply here. ICC considers that the protection against arbitrary reversal of proof is a right of any international investor. Therefore, as long as sufficient contemporaneous documentation is provided during a tax audit, the burden of proof should remain on the tax administration.

Given that tax authority audits could take place in years 4 or 5 following the transaction, there is a significant risk that any adjustment using ex post outcomes could result in significant interest and penalties for the taxpayer. We recommend that the OECD guidance clarify this point as there could be circumstances where it would be unfair to levy penalties where a good faith effort was made to price a transfer correctly and relevant documentation was in place to support the transfer.

ICC acknowledges that the HTVI guidance should not apply where the taxpayer has disclosed significant information (e.g. details of ex ante projections, how risks were factored in, appropriate considerations of “reasonably foreseeable events” etc.). However the guidance does not clarify how the threshold for information disclosure will be met. To this end a template of information required to give taxpayers clarity on these requirements would be desired to avoid increasing the administrative burden for the taxpayer.

The examples given are not wide-ranging for different industries, and do not appear to cover a scenario where the taxpayer does encounter an “unforeseeable event”. In the two papers published, the only reference to an “unforeseeable event” appears to be a natural disaster which has a low probability of occurrence. It would be helpful to provide a more diverse range of examples of unforeseen events, so taxpayers can gauge what scenarios need to be considered in their valuations.

Further, ICC would propose that the OECD take into account the varying levels of sophistication of tax administrations across the globe as well as their capabilities with respect to valuation of enterprises and to establish HTVI valuation methods and detailed implementation guidance accordingly. In addition, cases to serve as reference points in guiding tax administrations and multinational enterprises to properly conduct transfer pricing of HTVI would be useful in this regard.

The consultation draft states that the practical application of the exemptions listed will be reviewed by 2020 in light of further experience. Whilst the potential future flexibility could be useful once the guidance has been implemented, this could lead to further uncertainty for taxpayers, especially if at an early stage they need to consider whether a bilateral APA is the most appropriate approach to take to minimise the future risk of ex post adjustments.

[2] ICC believes that the taxpayer should only have to prove that the analysis was made in good faith, based on the information available at the time of the transaction and that the onus should be on the tax authorities to demonstrate that the taxpayer’s analyses were inaccurate and below the common standard of normal diligence / forecasts for such a transaction.

INTERNATIONAL CHAMBER OF COMMERCE
The world business organization
Commission on TAXATION

# The International Chamber of Commerce (ICC)
## Commission on Taxation

ICC is the world business organization, whose mission is to promote open trade and investment and help business meet the challenges and opportunities of an increasingly integrated world economy.

Founded in 1919, and with interests spanning every sector of private enterprise, ICC's global network comprises over 6 million companies, chambers of commerce and business associations in more than 130 countries. ICC members work through national committees in their countries to address business concerns and convey ICC views to their respective governments.

The fundamental mission of ICC is to promote open international trade and investment and help business meet the challenges and opportunities of globalization. ICC conveys international business views and priorities through active engagement with the United Nations, the World Trade Organization, the Organisation for Economic Co-Operation and Development (OECD), the G20 and other intergovernmental forums.

The ICC Commission on Taxation promotes transparent and non-discriminatory treatment of foreign investment and earnings that eliminates tax obstacles to cross-border trade and investment. The Commission is composed of more than 150 tax experts from companies and business associations in approximately 40 countries from different regions of the world and all economic sectors. It analyses developments in international fiscal policy and legislation and puts forward business views on government and intergovernmental projects affecting taxation. Observers include representatives of the International Fiscal Association (IFA), International Bar Association (IBA), Business and Industry Advisory Committee to the OECD (BIAC), Business Europe and the United Nations Committee of Experts on International Cooperation in Tax Matters.

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June 29, 2017

The Tax Treaties, Transfer Pricing and Financial Transactions Division
Centre for Tax Policy and Administration
Organization for Economic Cooperation and Development

Accounting & Tax Committee
Japan Foreign Trade Council, Inc.

**Comments on Discussion Draft on Action 8 (Implementation Guidance on Hard-to-value Intangibles of the BEPS Action Plan)**

The following are the comments of the Accounting & Tax Committee of the Japan Foreign Trade Council, Inc. ("JFTC") in response to the invitation to public comments by the OECD regarding the Public Discussion Draft on "BEPS Action 8: Implementation Guidance On Hard-to-Value Intangibles" released on May 23rd, 2017.

JFTC is a trade-industry association with Japanese trading companies and trading organizations as its core members. One of the main activities of the JFTC's Accounting & Tax Committee is to submit specific policy proposals and requests concerning tax matters. Member companies of the JFTC Accounting & Tax Committee are listed at the end of this document.

**General Comments**

- We appreciate the OECD's efforts to provide a certain approach toward such a difficult issue as Hard-to-value Intangible ("HTVI") in order to seek a common understanding and practice among tax administrations.
- However, while HTVI is difficult to value as the name suggests, entitling tax administrations to make adjustments based on the ex post outcomes on the assumption that the burden of proof is entirely put on taxpayers to demonstrate the appropriateness of the ex-ante pricing agreements may lead uncertainty of taxpayer's business and could discourage appropriate business decisions. Therefore, we strongly request additional guidelines on what is the base to determine as predictable as well as how to secure taxpayers' predictability (e.g. the HTVI approach is not applied in case that assumptions at the time of making projections and evaluation results have objective validity; such as

having a valuation report prepared by a third party or using public indicators in projections).

- In the first place, it should be kept in mind that intangibles have finite life cycle and cease to exist (lose value) at a certain point. Tax administrations should be aware that "post outcomes" at the time of implementing the HTVI approach still have uncertainties for the future and be careful in its implementation.
- Moreover, the HTVI approach should be confined to extraordinary circumstances and most importantly should only be allowed in a situation where elimination of double taxation is pre-guaranteed through mutual agreement procedure between the tax administrations involved.
- We appreciate that the OECD continuously monitors each government and tax administration in terms of maintaining a level playing field to make sure that there would be no countries which implement the HTVI approach inappropriately.

**Specific Comments**

■ 1. Introduction (Para 2.)

- While it is stressed in both paragraph 6.188 of the BEPS TP Report and this paragraph that ex post evidence should not be used without considering whether the information on which the ex post results are based could or should reasonably have been considered at the time of entering into the transaction, it would be beneficial to bring more clarity to "reasonable consideration" by adding detailed scenarios to the examples where tax administrations fail to give those considerations or conduct tax assessments solely based on hindsight.

■ 1. Introduction (Para 7.-Para 11.)

- We appreciate that it is pointed out that tax administration in every country should take into consideration the achievability of ex post outcomes taxpayers considered at the time of entering into the transaction. Also, it is urged to identify the evidence and carry out the assessment as soon as possible after the transactions are conducted. It is also preferable to assess at an appropriate timing without a long interval after the transaction from the viewpoint of administrative burden.
- On the other hand, in order to secure taxpayers' predictability, ex post outcomes should be used before the statute of limitations for audits expires.

■ 1. Introduction (Para 12.)

- As it is the underlying principle of the existing Transfer Pricing Guidelines not to re-characterize the existing contractual terms without careful consideration, it should be emphasized that upon resorting to altering the initial structure adopted by the taxpayer, tax administrations must first demonstrate strong rationale that the existing structure is inappropriate.

- 1. Introduction (Para 13.)
  - We believe contingent payment is a method adopted by the limited areas of industries, notably pharmaceuticals. It would be beneficial to emphasize the rarity of the instances such method is actually applied for the sake of clarity.

- Examples
  - The examples in this discussion draft only depict scenarios where the presumptive evidence based on the ex post outcomes are used to entitle tax administrations to make upward adjustments to the initial transfer price. It should be duly noted additionally in the Guidance, however, that the opposite circumstance may prevail even between third parties, where the actual income or cash flows are significantly lower than those on which the pricing was based, and therefore the HTVI approach should be carefully implemented..
  - The examples assume that the exemptions to the application of the HTVI approach contained in Para 6.193 are not applicable. However, examples where the exemptions are applicable should be added for clarification of the ways and the level of reasonableness taxpayers are required to prove in order to be exempted from the application.
  - The example depicts a situation where the tax administration is entitled to use the presumptive evidence based on the ex post outcome due to the taxpayer's inability to "demonstrate that its original valuation properly took into account the possibility that sales would arise in earlier years, and…that such a development was unforeseeable." We fear that in absence of a detailed portrayal about the circumstances why the taxpayer has failed to demonstrate the appropriateness of the initial pricing, tax administrations may be more inclined to make arbitrary assessments than they would have with proper guidelines which specify why the taxpayer has failed to demonstrate and what points tax administrations focus on in their determination in order to secure taxpayers' predictability"

- Scenario A (Para 19.-Para 21.)
  - Scenario A describes as "the tax administration of Country A…obtains information

that commercialization in fact started during Year 3 since Phase III trials were completed earlier than projected….The tax administration is entitled to make an adjustment to assess the additional profits of 300 in Year 0”. However, the buyer (Company S)’s contributions after the intangible was transferred and other external factors should be considered comprehensively when determining the necessity of adjustment. If the tax administration decides to make an adjustment, they must make a reasonable explanation to the taxpayer about their decision after conducting the above mentioned analysis.

- Example 3
  - (Para 31)

    Considering the high possibility that the application of the HTVI approach would result in double taxation, resolution through the mutual agreement procedure should not only be “permitted”, but rather be made compulsory. In particular, primary adjustments with respect to closed tax years should not be allowed in absence of a viable mutual agreement between the tax administrations concerned.

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June 30, 2017

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The Organisation for Economic Co-operation and Development

International Tax Committee
Japan Machinery Center for Trade and Investment

Comments on the Discussion Draft of "Implementation Guidance on Hard-to-Value Intangibles"

Japan Machinery Center for Trade and Investment ("JMC") is a non-profit organization that was established in 1952 to promote sound development of foreign trade relating to machinery in Japan by multi-national entities ("MNE"), and includes the major machinery manufacturers, trading companies, and engineering companies. To enhance the international competitive strength of the machinery industry in Japan, an international tax committee was established in beginning of 1990 to study and encourage the developments of domestic and foreign international taxation systems.
URL：http://www.jmcti.org/jmchomepage/english/index.htm

Transfer pricing issues of intangibles discussed in BEPS Action 8 have very important implications on the business of the member companies of the JMC, which deal in export and investment of machinery equipment including high-tech machinery. Thus, in addition to fully supporting the comments by KEIDANREN to the OECD, we decided to submit our own comments, which particularly related to the circumstances of the JMC member companies.

<General Comments>

The discussion draft provides some guidance for tax administrations regarding the treatment of hard-to-value intangibles (HTVI) with a view to tackling information asymmetry between the taxpayer and the tax administration. We hope that, based on this guidance, common understanding among tax administrations of different countries is promoted.

The discussion draft discusses the possibility of considering the *ex post* outcome as presumptive evidence on the appropriateness of the *ex ante* pricing arrangements. While the taxation based on the *ex post* outcome only is not permitted, some examples are indicated regarding the estimates based on the *ex post* outcomes in case taxpayers cannot provide explanation on the attainability and foreseeability at the time of the initial valuation. From the viewpoint of taxpayers, it is important to have a clear understanding on the proof of attainability and foreseeability. However, as no clear guidance on the evidence for that proof is indicated, taxpayers can be in trouble in the course of actual business. We believe that further guidance has to be indicated clearly. That point is also important for avoiding too broad interpretation by the tax administration.

It is likely that different tax administrations have different views on the *ex post* adjustment, and taxpayers are concerned that it might cause the double taxation. The approach of the discussion draft should be implemented after the effective mutual agreement procedure is established and the international agreement on the dispute resolution mechanism is attained, as mentioned in paragraph 31-32.

The discussion draft provides some examples, making reference to the condition that the approach to HTVI ("commensurate with income standard" in the subsequent part of our comment) is not applied. Thus, it can be useful for understanding the operation mechanism of "commensurate with income standard".

We want to have clearer explanation on the following point:
As indicated in paragraph 6.193 of the Guidelines, "commensurate with income standard" is not applied when the taxpayer provides:

1. Details of the *ex ante* projections used at the time of the transfer to determine the pricing arrangements, including how risks were accounted for in calculations to determine the price (e.g. probability-weighted), and the appropriateness of its consideration of reasonably foreseeable events and other risks, and the probability of occurrence; and,
2. Reliable evidence that any significant difference between the financial projections and actual outcomes is due to: a) unforeseeable developments or events occurring after the determination of the price that could not have been anticipated by the associated enterprises at the time of the transaction; or b) the playing out of probability of occurrence of foreseeable outcomes, and that these probabilities were not significantly overestimated

or underestimated at the time of the transaction.

In the examples in the discussion draft, the operation mechanism of "commensurate with income standard" is explained on the presumption that taxpayers cannot explain the unforeseeability at the time of the transaction. In practice, even if the taxpayer explains the unforeseeability, the tax administration might figure that the explanation of the taxpayer is not reliable. We hope that the guidance is provided in the examples on the reason of the judgement by the tax administration concerning the explanation by the taxpayer and on the concrete conditions required for the sufficient proof by the taxpayer which can be judged as being reliable by the tax administration.

<Introduction>

1. We appreciate the efforts made by the party concerned in that the implementation guidance is arranged within the framework of the arm's length principle. At the same time, we would like to reassure that the arm's length principle is fully esteemed. We consider that it should be clearly indicated that the application of "commensurate with income standard" is limited to the cases where the pricing of intangibles between associated enterprises deviates from the arm's length principle.
2. Paragraph 6.192 of Guidelines refers to "the determination of the arm's length arrangements, including any contingent pricing arrangements that would have been made between independent enterprises at the time of the transaction". However, contingent pricing arrangements are not usually used, or only used very rarely in transferring intangibles between independent enterprises. Because ex post adjustment of prices of intangibles is seldom implemented between independent enterprises, the scope of the application of "commensurate with income standard" on associated enterprises should be limited strictly.
3. In the examples in the discussion draft, a pharmaceutical compound is illustrated. However, use of a pharmaceutical compound does not necessarily seem be useful as a guidance for machinery industries where a lot of patents and other intangibles are used for one product.
4. We understand that one product is protected by one or several patents in the case of pharmaceutical compound. In the case of machinery, including electric or transportation machinery, thousands or even ten thousands of patents are used for one product. When only one or several of these numerous patents are transferred, it is virtually impossible to evaluate the profit produced by the transferred patents.
5. Therefore, we think that the application of "commensurate with income standard" should be limited to the following cases of large-scale or important transfers of intangibles: (i)

So many patents for one product are transferred to overseas associated enterprises that the transfer of these patents has an important influence on the sales of that product. (ii) The scope of regions where the transferred patents are protected is so wide that the amount of sales of the product using the patents in these regions is large and important. (For example, while the parent company keeps the right to sell the product within the resident country of the company, the right to use the patents in any other counties or regions is transferred to an overseas associated enterprise.)

6. In other words, "commensurate with income standard" should not be applied in the following cases unless they involve large scale and important transactions indicated in 5. above. Instead, the pricing based the cost of research and development for the invention (cost plus method) should be admitted. (i) The case in which the inventions by overseas subsidiaries on consignment development are transferred to the parent company based on the policy to concentrate intellectual property to the parent company. (ii) The case in which the parent company buys the patent developed independently by an overseas subsidiary.

<Example 1>

1. In Example 1, the reason why the tax administration corrects the price from 700 to 1,000 is the sales are realized earlier than anticipated, but it seems that this fact alone is not sufficient to conclude that the price should be corrected upwards retroactively. It might be the case that the efforts by the patent buyer made the earlier sales possible. More explanation is needed on the conditions of this example.
2. If the Phase III trial was completed earlier because of the efforts by the company that purchased the patent, it is more reasonable from an economic point of view to allocate the increased profits to that purchasing company.
3. Paragraph 19 (and also 24) refers to the explanation by the taxpayer on the properly taking account of the possibility at its original valuation and on the unforeseeability of the development. We would like you to provide us with clearer guidance about the expected level of proof.

<Example 2>

1. In Example 2, the timing of correcting the price does not retroact to the time of transaction (Year 0) as in Example 1, but only to Year 3. However, there is no essential difference between them because the price correction retroact to previous years from the audit period in both examples.
2. "The successful completion of development phases or regulatory approvals in a particular

market" (in paragraph 28) might due to the efforts made by company that purchased the patent. Therefore, it is not reasonable to conclude that the price should be corrected upwards retroactively based on that fact only. More explanation on the factual background is needed.

3. Paragraph 28 reads that "this paragraph in not intended, and does not, imply that modification of the payment form can only occur when there is a common practice in the relevant business sector regarding the form of payment for the transfer of a particular type of intangible." However, we cannot agree to the notion that the concept of "additional contingent payment" is applied regardless of the common business practice.
4. Example 2 seems to imply that the tax administration can construct a contract that include contingent payment clause, which did not exist in the original contract, and can tax at the time of contingent payment, regardless of the actual price setting practice in the relevant business sector. To dare to take that approach, although the same result can be achieved by taxing at the time of the initial transaction, seems to imply to virtually abolish the statute of limitation and to come close to introduce the income recalculation after the all actual data are available. From the viewpoint of taxpayers, the statute of limitation is useful in mitigating the tax risk and constructing a contract by the tax administration goes too far.

<Example 3>

1. In deciding the royalty payment rate during the contract period, it might be common in the pharmaceutical patent to determine the rate by dividing the value of the intangible (700) by the present value of sales over the contact period (3,500); in this example, 700/3,500=20%. However, this method is not generally used in the machinery industry, where so many patents are used for one product.
2. In the machinery industry, it is next to impossible and unrealistic to evaluate each patent one by one. Thus, in many cases, low royalty rate as a ratio of sales of patented products or small amount of royalty per one unit of patented products are set in the price negotiation between the licenser and the licensee, taking the "industry standard" into account. In these cases, it is virtually impossible to reevaluate each patent even *ex post*. Thus, it seems to be difficult for the tax administration to implement transfer pricing taxation by correcting the royalty rate *ex post*.
3. However, to the case of large-scale or important transactions of intangibles as explained in <Introduction>5, the approach presented in Example 3 might be applicable. Therefore, in examining the applicability of "commensurate with income standard", the scope should be limited to these cases as indicated in <Introduction> 5.

4. Example 3 illustrates the situation where the received royalty is corrected upwards in case the income or cash flow increase more than expected and that the taxpayer cannot demonstrate that it was unforeseeable. We wonder if there can be a case in which royalty payment is corrected downward (denial of inclusion in expenses of the royalty payment) when the income or cash flow is lower than expected in the application of “commensurate with income standard”.

<HTVI and the Mutual Agreement Procedure>

1. Whether “Commensurate with income standard”, which is to be applied to “hard-to-value” intangibles, works in practice or not critically depends on the effective function of the adjustment of double taxation through the mutual agreement procedure. Therefore, the importance of the effective function of the mutual agreement procedure cannot be emphasized too much.
2. From the view point of taxpayers, we request that the tax administration, which is to start to apply transfer pricing taxation based on “commensurate with income standard”, goes into the mutual agreement procedure with the other tax administration and that the upward correction by the tax administration is implemented simultaneously with the downward correction by the other tax administration, after the agreement is reached between these tax administrations to avoid the double taxation.
3. The discussion draft does not examine the relationship between “commensurate with income standard” and mutual agreement procedure in details, and indicates that this issue is to be discussed in the framework of BEPS Action 14. We hope that the tax administration which applies transfer pricing taxation based on “commensurate with income standard” is strongly requested to resolve the double taxation issue, without delay, through the effective mutual agreement procedure.
4. In case the implementation guidance on “commensurate with income standard” of hard-to-value intangibles are published as the final report, the double taxation adjustment through the mutual agreement procedure should be included in the final report as a set of the implementation guidance.
5. On the adjustment of double taxation through the mutual agreement procedure should become effective as the binding implementation guidance, even if it is not a part of the Guidelines itself. Otherwise, we are concerned that the risk of double taxation might further increase than before

The topic discussed in the discussion draft is very relevant and important for many Japanese exporting companies, and the JMC would like to thank the OECD for providing us with the opportunity to comment on the discussion draft.

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Copenhagen, 30 June 2017

Dear madam, sir

**Comments to the BEPS Action 8 Implementation Guidance on Hard-to-Value Intangibles, Public Discussion Draft, 23 May-30 June 2017**

Thank you for continuing to allow public input into WP6's work; it is much appreciated. I am an international tax professional and the Danish managing director for Quantera Global a transfer pricing boutique firm. My comments in this letter are made on personal title.

I divide my comments in the good and the missing. I will be brief on each point, but am happy to explain any point in further depth, should you wish me to.

## The good

1. Thank you for encouraging tax administrations to act sooner rather than later when investigating HTVIs (e.g. paragraph 13, last bullet). Doing otherwise could increase the risk of double taxation through mismatches in statutes of limitations.
2. It is good that paragraph 32 explicitly ties the application of the special measures allowed for HTVIs to Action 14. In view of these enhanced powers and the inherent subjectivity underlying the exemptions of paragraph 6.193.i of the post BEPS Transfer Pricing Guidelines (the "TPG"), it is even worth considering the following. Include a recommendation for authorities to follow article 16'2, last sentence of the Multilateral Convention to implement tax treaty related measures to prevent Base Erosion and Profit Shifting (the "MLI") and not to apply the reservation possibility of article 16'5.c with regard to HTVIs.
3. It is good that footnote 1 encourages countries to resolve cases of double taxation "at least for open years under statute of limitation rules that would have applied if the country making the corresponding adjustment had itself made the primary adjustment." It would be even better if the language quoted above from the MLI and article 15'2 of the OECD Model Convention itself are referenced. It seems appropriate to state that a deviation from article 15'2, last sentence, and an adherence to that deviation, is not in line with BEPS Action 14.

## The missing

I believe that there are some issues with the new TPG chapter 6.D which require further clarification, and would think that the current draft document provides the opportunity to do that.

4. I have difficulty in understanding the relation between intangibles (including HTVIs) and profit potential referred to in chapter 9. Is profit potential an HTVI (unlikely considering the language of chapter 9); is profit potential an attribute of an HTVI; or is profit potential something besides tangibles and intangibles

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(e.g. the difference between the going concern value of an enterprise and sum of its total tangibles and intangibles)? If the latter is the case, it will be good to know if the principles of § 6.188 – 6.194 apply as well.

5. There is an ambiguous sentence in §6.188: "Such presumptive evidence may be subject to rebuttal as stated in paragraphs 6.193 and 6.194, if it can be demonstrated that it does not affect the accurate determination of the arm's length price." where the second "it" either refers to "presumptive evidence" or "it" refers to the "rebuttal". I find it difficult to understand either alternative. I assume it is should read (summarised) "presumptive evidence can be rebutted if the presumptive evidence does not affect the determination of the arm's length price." but I still do not know what it means. Does it mean that if the presumptive evidence does affect the arm's length price, then rebuttal is not possible? If yes, does that then mean that this sentence constitutes a threshold for 6.193 (not logical considering the fact that the thought process behind chapter 6.D.4 seems to be linear and then a throw-back from 6.193 to 6.188 makes no sense); if no, then why the "if", which makes the sentence conditional? Can this be explained in the implementation guidance?
6. There is the question whether the possibilities of the rebuttal of the presumptive evidence is limited to the examples given in 6.193 (which the current wording of 6.188 and 6.193 imply), and if so, why. It seems fair as a matter of principle that presumptive evidence should be allowed to be rebutted in any possible way, as long as the rebuttal is credible.
7. To what extent are taxpayers themselves allowed to apply the ex post presumptive evidence to justify spontaneous adjustments to previously made transfers of HTVI's? After all, honest mistakes do happen.
8. The guidance given in § 6.188 on the difference between using ex post outcomes as presumptive evidence and using hindsight is a useful differentiation. It will help taxpayers and tax authorities alike if it is clearly made applicable to the rest of the TPG as well.
9. Example 1, scenario B, stops with mentioning that even if the ex post presumptive evidence procedure does not apply, the rest of the TPG still do. Though I cannot condemn it outright, I have mixed feelings about having a rule (HTVI), providing a safe harbour to that rule (§ 6.193), and then taking the safe harbour away again. It would be nice if this conclusion that the rest of the guidelines still apply can at least be accompanied by the clear statement that the use of ex post outcomes as presumptive evidence is NOT available to tax authorities in such a case.

Yours sincerely,

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June 30, 2017

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**Comments on the Public Discussion Draft on BEPS Action 8**
***Implementation Guidance on Hard-to-Value Intangibles***

**Introduction**

The OECD is currently working on a number of matters related to its recommendations on base erosion and profit shifting (**BEPS**) under the Inclusive Framework. These include implementing peer review of the minimum standards, addressing remaining issues such as those pertaining to transfer pricing taxation and the digital economy, and tackling the issue of tax certainty. Keidanren continues to support these initiatives and remains committed to constructively engaging in associated tasks.

The BEPS Project has resulted in the inclusion of the approach to hard-to-value intangibles (hereinafter, "**the HTVI approach**") in the revised Chapter VI (Special Considerations for Intangible Property) of the OECD Transfer Pricing Guidelines.

In previous discussions, there was a phase during which the HTVI approach was proposed as a potential special measure with the satisfaction of the arm's length principle not being a critical issue. However, the HTVI approach has been ultimately defined as a measure within the arm's length principle. For this, we appreciate the efforts of the relevant parties.

On the other hand, as the HTVI approach grants tax administrations the powerful authority to make adjustments based on ex-post outcomes, we cannot dismiss concerns that the HTVI approach may give rise to taxes imposed in hindsight. The inappropriate application of the HTVI approach may in some cases give rise to unresolvable double taxation and impose on taxpayers an undue administrative burden, including documentation creation and maintenance and a requirement to provide detailed explanation during audit.

Each country should recognize that ensuring tax certainty has become an increasingly important issue for the OECD and the G20 in recent years, and acknowledge that the HTVI approach is applicable only to a limited number of unique tax-avoidance schemes. In this regard, the OECD is expected to issue detailed and rigorous guidance regarding the definition of hard-to-value intangibles, how exemptions to the application of the HTVI approach should be interpreted, and how double taxation should be prevented and resolved.

Although we welcome the Implementation Guidance as a useful resource for providing an explanation of the application of the HTVI approach per se, our view is that it lacks adequate explanation of the exemptions. Further explanation is also required with regard to the statute of limitations rules, and the elimination of double taxation.

In light of the above, we provide our comments below.

**1. General Comments**
**(1) Enhancement of guidance on exemptions**
**(i) Appropriateness of taxpayers' ex-ante projections**
Paragraphs 19 and 24 of the Implementation Guidance generally illustrates the application of the HTVI approach to a situation where taxpayers are unable to explain the appropriateness of their ex-ante projections. However, in practice, the first question asked would be in what circumstances a tax administration would be convinced by a taxpayer's explanation.

When transferring an intangible, an enterprise usually determines the price by taking into account a variety of factors, such as future earnings projections, similar prior transactions, the buyer and seller's positions, and the negotiation process. As such, the transaction price, as determined at the time of entering into the agreement, should be presumed to have sufficient economic rationality. Accordingly, supporting documentation and explanation provided by the taxpayer should be respected.

For situations that still require consideration of the application of the HTVI approach, easy-to-understand guidance, coupled with illustrative examples, should be provided to assist taxpayers in the preparation of information indicating that their position is valid. Furthermore, the guidance should also include the criteria by which a tax administration should assesses a taxpayer's evidence.

Specifically, further guidance should be provided on the meaning of such terms as "*details of . . . the probability of occurrence*" of events referred to in item (i)1 of paragraph 6.193 of the OECD Transfer Pricing Guidelines, and "*reliable evidence*" in item (i)2 of the same paragraph. For example, in cases where a transaction has been conducted between associated enterprises and an independent third-party valuation of the intangible has been obtained, it is not clear whether the reliability of the valuation will be considered. The Implementation Guidance should also provide an example of inappropriate cases in which, despite a taxpayer having provided sufficient documents and explanations, the tax administration applies the HTVI approach in hindsight.

**(ii) Additional exemptions**
Cases to which the HTVI approach applies should be substantially restricted in order to minimize the risk of double taxation. Given the HTVI approach has been proposed in the context of the BEPS Project, a possible way of achieving this is to restrict its application to transfers of hard-to-value intangibles to low-tax jurisdictions.

In addition, consideration should be given to certain industries, such as manufacturers of electronics, machinery, and transportation equipment. In such industries, the creation of a single product requires the use of several to tens of thousands of patents and other intangibles. It follows that what contributes to a product's earnings is not a single intangible but an intricate combination of countless intangibles, which makes accurately valuing each intangible extremely difficult. Accordingly, it is conceivable that the application of the HTVI approach is limited to cases where there is a clear correlation between the transferred intangible and the transferee's sales, or where the transferred intangible has significant monetary value.

We submit that a statement should be added to the Implementation Guidance clarifying that jurisdictions are allowed to create these additional exemptions at their discretion.

**(2) Handling of statutes of limitations**

We are concerned that going forward, an increasing number of jurisdictions may consider extending the statute of limitations on transfer pricing assessments, for the following reasons.

First, an exemption to the HTVI approach applies where "*a commercialisation period of five years has passed*", as provided in item (iv) of paragraph 6.193 of the OECD Transfer Pricing Guidelines. Second, there may be cases where the transferred intangibles require a certain "*incubation*" period as mentioned in paragraph 8 of the Implementation Guidance. An extension of the statute of limitations would undermine predictability for taxpayers and increase tax uncertainty.

While the Implementation Guidance states at paragraph 10 that "*nothing in this guidance changes those time limits, which are a matter of sovereignty of countries*", it also states at paragraph 11 that "*it does not prevent countries from considering targeted changes to procedures or legislation*."

The issue is that the level of BEPS risks varies from country to country. To preclude a country with negligible BEPS risks from unnecessarily extending the statute of limitations on the pretext of introducing the HTVI approach, the Implementation Guidance should emphasize that each jurisdiction is required to carefully consider the existence and extent of tax avoidance obtained by taking advantage of hard-to-value intangibles.

**2. Examples**

We begin with three overall comments. First, paragraph 15 of the Implementation Guidance, which explains the assumptions that inform the examples, should explicitly state that there exists an information asymmetry between taxpayers and tax administrations.

Second, whereas all the examples are premised on the use of the discounted cash flow (**DCF**) method, the DCF method is not the only available valuation methodology. Therefore, we agree with what is stated in paragraph 16.

Third, we consider it useful, from a comparative perspective, to add examples that illustrate cases in which the actual income or cash flows are lower than the anticipated income or cash flows.

**(1) Example 1**

**(i) Scenario A**

The key to this scenario is to what extent Company A, at the time of transferring the intangible property, appropriately accounted for the possibility that Company S's Phase III trials might be completed, and commercialization would commence earlier than projected. Despite this, the example does not adequately explain pertinent points, such as how Company A evaluated the management efforts made by Company S (to which the intangible was transferred), and what efforts were made by Company S. Information with regard to these points should be included.

Furthermore, in this example pertaining to pharmaceuticals, the reasonableness of the compensation for the transfer, determined at the time of the transaction, should have been verified considering the product's life cycle. However, the example appears to focus solely on the profits generated in periods when sales were strong. For example, where, in subsequent years, the taxpayer suffers declining sales and losses resulting from the emergence of competing products or side effects, would the taxpayer be allowed to request a readjustment? In this regard, we would expect the Implementation Guidance to provide clearer guidance.

**(ii) Scenario B**

In this example, one of the exemptions to the HTVI approach is applied because the adjustment to the compensation for the transfer is within 20% of the compensation determined at the time of the transaction. However, even if the adjustment were to exceed the 20% range, it might make more sense to reassess the portion exceeding 20% only, and not the entire adjustment.

At present, when exceeding the transfer pricing range set by the bilateral advance pricing arrangement, an adjustment is usually made to the median of the range; and there may also be cases where an advance agreement is reached with the counterpart country on the point that an adjustment will be made to the closest edge of the range. Ex-ante projections related to transfers of hard-to-value intangibles are difficult to make and inevitably involve uncertainty. We are therefore of the view that, even in cases to which the HTVI approach applies, the method proposed above is worth considering from the perspective of minimizing double taxation.

Paragraph 23 provides that, "*Notwithstanding that the HTVI approach does not apply, an adjustment under other sections of these Guidelines may be appropriate*." This statement is confusing in that it may render the creation of the exemptions meaningless. At the very least, an explanation should be provided as to what adjustment is being referred to.

**(2) Example 2**

Based on the premise that it is common in the pharmaceutical sector to transfer patent rights to independent parties through a combination of initial lump sum payments and additional contingent payment arrangements, this example concludes that the tax administration is entitled to make adjustments, assuming an additional contingent payment was made in a subsequent year. However, paragraph 28 states that "*this paragraph is not intended to, and does not, imply that modification of the payment form can only occur when there is a common practice in the relevant business sector regarding the form of payment*."

We are concerned that this statement may make the example's conclusion broadly applicable to any industry. Assume that a tax administration adjusts the compensation for the transfer determined at the time of the transaction with respect to a tax year on which the statute of limitations has not expired and, in the case of such adjustment being impossible due to the statute of limitations, adjusts additional income in subsequent years. Such extreme enforcement in an unrestricted manner could effectively undermine the statute of limitations rules. We consider that the application of this conclusion should be limited to cases where the agreement concluded between associated enterprises has clauses stipulating additional payments or contractual renegotiation.

**(3) Example 3**
As mentioned earlier, in industries such as electronics, machinery, and transportation equipment, a single product is manufactured using a combination of countless intangibles. In light of that, the method illustrated in this example (using the net present value of sales over the period of the agreement to arrive at the value of the intangible and determine the royalty rate) is not practical. We expect examples dealing with non-pharmaceutical industries to also be provided.

In addition, attention should be paid to the fact that, even if a tax administration applies the HTVI approach and assesses additional royalty income, remittance regulations imposed by some countries may make the situation difficult to resolve.

**3. Relationships with Mutual Agreement Procedures**

As long as the HTVI approach is a measure within the arm's length principle, any double taxation arising from the application of the approach must be resolved. In this regard, the word "*permit*" used in paragraph 31 of the Implementation Guidance is too vague. To start with, jurisdictions introducing the HTVI approach should fully commit themselves to implementing mutual agreement procedures. Similarly, the implementation of mutual agreement procedures should be a prerequisite for the application of the HTVI approach.

Furthermore, to ensure disputes are resolved, individual countries should continue working to include arbitration provisions in their tax treaties.

Sincerely,

Subcommittee on Taxation
Keidanren

KPMG

KPMG International

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| To | Tax Treaties, Transfer Pricing and Financial Transactions Division, OECD/CTPA | Date | June 30, 2017 |
| From | KPMG International | Ref | Comments to the OECD: BEPS Action 8: Implementation Guidance on Hard-to-Value-Intangibles |
| CC | Stephen Blough, KPMG US<br>Manal Corwin, KPMG US | | |

**Comments on the Discussion Draft on Implementation Guidance on Hard-to-Value Intangibles**

Professionals in the member firms of KPMG International ("KPMG") welcome the opportunity to comment on the OECD's Discussion Draft titled *BEPS Action 8: Implementation Guidance on Hard-to-Value-Intangibles* (the "Discussion Draft").

KPMG commends the OECD for the effort it has expended under the BEPS project and recognizes how far it has come in the few years since it first embarked on the project. The OECD has solicited and received comments from the public, and reflected many of the comments in the guidance it has released so far. KPMG appreciates that the OECD is continuing with its collaborative approach and requesting input from the public on this latest Discussion Draft. KPMG's comments on the Discussion Draft are included below, which it hopes will contribute to the OECD's work on its next version of the hard-to-value intangibles ("HTVI") implementation guidance.

**Background and Summary**

The Discussion Draft follows a large body of transfer pricing work from the OECD on its BEPS project, including a significant rewrite of Chapter VI and parts of Chapter I of the OECD Transfer Pricing Guidelines. This work reflects the evolution of the OECD's thinking on dealing with base erosion and profit shifting (BEPS) related to transfer pricing. In the early days of the BEPS project, the OECD was considering whether to work within the arm's length principle or to introduce special measures outside the arm's length principle to effectively combat BEPS. After careful consideration, it reaffirmed the longstanding arm's length principle as the international standard for transfer pricing and concluded that BEPS concerns could sufficiently be addressed within the arm's length principle.

The revised Chapter VI released in 2015 includes guidance on the transfer pricing of HTVI[1]. In keeping with the broad conclusion of the OECD that the arm's length principle is sufficient to address BEPS concerns, the HTVI guidance is intended to operate consistently with the arm's length principle. The Discussion Draft presents the principles that should underlie the implementation of the HTVI approach.

The key themes of KPMG's comments on the Discussion Draft are as follows:

- The ultimate goal of the HTVI implementation guidance, as noted in the Discussion Draft, is to improve consistency and reduce the risk of double taxation resulting from the application of the HTVI approach. The Discussion Draft will benefit from clearer implementation guidance related

[1] Note that this memo will use the abbreviation HTVI for hard-to-value intangibles in the singular or plural, depending on the context.

to several aspects of the HTVI approach that are likely to be sources of conflict or differing interpretations between tax authorities and/or taxpayers.

- From a practical standpoint, much of the challenge with HTVI is the uncertainty created for taxpayers and tax authorities. While providing clearer implementation guidance on the HTVI approach would help to mitigate some of this uncertainty, it is unlikely to eliminate it. This uncertainty reinforces the importance of the OECD's work on making dispute resolution mechanisms more efficient and robust. The Discussion Draft could do more to encourage mechanisms to avoid HTVI-related disputes and to resolve them quickly should they arise.
- While the "HTVI approach" allows a tax authority to consider *ex post* outcomes as presumptive evidence about the appropriateness of the *ex ante* pricing arrangements, it is not meant to repudiate the arm's length principle. The Discussion Draft acknowledges that *ex post* evidence should not be used without considering whether the information on which the *ex post* results are based "could or should reasonably have been considered"[2] by the taxpayer. However, the Discussion Draft does not contain any guidance on how to determine that the taxpayer acted reasonably. As a result, the Discussion Draft increases the risk that the HTVI approach may be applied as a *per se* rule that is inconsistent with the arm's length principle. The Discussion Draft does provide that even when a tax authority may appropriately apply the HTVI approach, the tax authority should weight the *ex post* results for their *ex ante* probability; however, the Discussion Draft contains no indication of how the appropriate probability attached to particular *ex post* results should be determined. We believe that absent specific guidance on these issues, natural hindsight bias will create a high likelihood that, first, the HTVI approach will be applied when the taxpayer could not reasonably have considered the *ex post* results and, second, that the probability attached to the *ex post* results will be too high. We recommend that the Discussion Draft be revised to include a discussion of factors that may be introduced to rebut the evidentiary presumption that the HTVI approach may be applied and, if the HTVI approach may properly be applied, to attach an appropriate probability to the *ex post* results. We further suggest including examples that illustrate the application of these factors.
- While the Discussion Draft encourages tax authorities to apply audit practices to ensure that presumptive evidence based on *ex post* outcomes should be identified and acted upon as early as possible, it does not suggest any guidelines to ensure that tax authorities do so. On the contrary, by liberally describing the approaches that tax authorities may use to implement adjustments under the HTVI approach (*e.g.*, through the imputation of "milestone payments" (para 12)), the Discussion Draft raises the prospect that taxpayers may face adjustments in open tax years that actually relate to returns that were earned in closed periods and, therefore, that had been known and previously auditable. Given the substantial policy considerations that support statutes of limitations for tax assessments, we believe that the guidelines should reflect that while the returns from the intangible property for all periods may be considered in determining whether a tax authority may apply the HTVI approach, the actual adjustment should be limited to returns attributable to open tax years.

We provide some specific comments below.

**Specific Comments**

***Greater clarity on arm's length application of the* HTVI approach**

The "HTVI approach" proposed by the Chapter VI guidance permits tax authorities to consider *ex post* outcomes as presumptive evidence about the appropriateness of the *ex ante* pricing arrangements.

[2] Paragraph 2 of Discussion Draft.

Such *ex post* information, by definition, was not available to the parties when entering into the transaction and therefore its use cannot replicate conditions between parties negotiating at arm's length. However, the OECD believes that tax authorities should be permitted to use *ex post* information to address perceived information asymmetry between the taxpayer and tax authority. Use of *ex post* outcomes as presumptive evidence presumes that differences between *ex post* outcomes and *ex ante* projections are a result of the taxpayer's mispricing the HTVI transfer given the information available to it, and further that the use of *ex post* outcomes is necessary to more closely reflect the information that the taxpayer actually had at the time of the transfer.

The HTVI approach outlined in the Discussion Draft also authorizes tax authorities to make adjustments that reflect alternative pricing structures different from those adopted by taxpayers. KPMG believes that the combination of presumptive use of *ex post* information along with authority to reflect alternative pricing structures is likely to substantially increase tax uncertainty[3] and the risk of double taxation. This risk is significant and calls for significantly more guidance from the OECD to provide targeted, consistent implementation of the HTVI approach.

***Addressing hindsight bias***

Because the HTVI approach merely creates a presumption, and not a rule, a taxpayer should be able to rebut the presumption that it did not appropriately consider the available information to price the transaction.[4] As the Discussion Draft acknowledges, the HTVI approach is not intended to be used as an alternative to arm's length pricing.

While the Discussion Draft addresses the potential problem of a taxpayer mispricing HTVI based on available information to its advantage, the Discussion Draft largely overlooks the very significant risk that a tax authority will use *ex post* information to apply the HTVI approach when the taxpayer could not reasonably have anticipated the *ex post* results and therefore to price transactions in a manner inconsistent with the arm's length principle. This risk arises from the natural human tendency to conclude that anything that has happened could have been anticipated and, moreover, that what has occurred was either destined to occur or at least likely to occur. Because tax authorities examining a transaction will always have *ex post* information that was not available to the taxpayer at the time of the transaction the risk of hindsight bias is, given human nature, almost unavoidable. Addressing this bias is not only in the interest of taxpayers, but also in the interest of any tax authority impacted by the transaction but not asserting the application of the HTVI approach.

[3] At the G20 Summit in Hangzhou in September 2016, recognizing the harmful effects of tax uncertainty on investment and trade, the G20 requested that the OECD and IMF work on the issues of pro-growth tax policies and tax certainty. On March 18, 2017, the OECD and IMF issued their report on Tax Certainty. This report identified key areas of concern causing tax uncertainty and recommendations to address these concerns.

[4] The Discussion Draft appears to be focused on situations where the HTVI has especially high returns. In the interest of symmetry, the OECD should also acknowledge that HTVI may yield especially low returns.

To mitigate what we believe to be a substantial risk of hindsight bias, we strongly recommend that the Discussion Draft be revised to provide guidance as to the evidence that a taxpayer (or another tax authority) may introduce to rebut the presumption that the HTVI approach may be applied or to determine the appropriate probability to attach to the *ex post* results.[5] These factors may include the following, among others:

- Contemporaneous non-tax projections—Taxpayers routinely prepare projections for a variety of non-tax reasons. For example, management may require an R&D staff to prepare an economic feasibility analysis to secure funding for a project. In such a case, the R&D staff is unlikely to prepare an analysis that understates the project's expected benefits. As other examples, forecasts presented to company Boards, investors, third party financial analysts or other stakeholders should be considered *bona fide* forecasts. Further, where an intangible is acquired from a third party and then transferred intercompany, forecasts that tie to the acquisition price should be considered *bona fide* forecasts for the purpose of rebutting a tax authority's attempt to apply the HTVI approach.
- Stage of development—The stage of development of the IP when it is transferred is also likely to bear on the appropriateness of applying the HTVI approach or attaching a high likelihood of success to optimistic outcomes. There is likely to be significantly less "information asymmetry" between the taxpayer and the tax authority early in the development process than after the taxpayer has resolved all the technical issues but just before commercial launch of a product.
- Existence of competitive IP—If, at the time IP is being transferred, other IP exists or is being developed (*e.g.* by competitors) that would affect the profits expected to be earned from the IP under review, the taxpayer's contemporaneous contemplation of the existence of that competing IP is relevant in assessing reasonably expected outcomes from the IP under review, even if such competing IP is *ex post* unsuccessful or uncompetitive.
- Independent analysts' reports—Contemporaneous market analyses of independent firms may provide valuable insight into reasonable *ex ante* expectations. For example, if taxpayer projections were in line with industry forecasts and *ex post* results for the taxpayer and the industry exceed projections to similar extents, that would evidence that *ex post* results were due to unanticipated factors.
- Subsequent events—Unforeseeable events involving third party competitors could increase or decrease the value of a taxpayer's IP after the IP has been transferred in a controlled transaction. For example, a competitor with equivalent IP may be forced from the market due to government expropriation, management fraud, or poor results from its other lines of business, thereby leading to an unforeseeable increase in the value of the taxpayer's IP.
- Emergence of unanticipated fields of use—In certain circumstances, IP developed for one purpose may, after it is transferred in a controlled transaction, be discovered to have a completely unanticipated application that greatly increases its value. For example, a drug being developed to treat high blood pressure may unexpectedly be found to be an effective treatment for diabetes, greatly increasing its value.

[5] The only example of unforeseeable events mentioned in the 2015 Actions 8-10 Report guidance is a natural disaster. (See Aligning Transfer Pricing Outcomes with Value Creation (2015), para 6.194. However, the Report acknowledges that any "unexpected event that was clearly unforeseeable at the time of the transaction or appropriately given a very low probability of occurrence" will result in respecting the *ex ante* pricing arrangement as arm's length. (Id.). We believe that the HTVI Implementation Guidance mandates more clarity for the other types of unforeseeable events that warrant respecting the *ex ante* pricing arrangement. Including the following examples in the Implementation Guidance would help provide much needed clarity.

- Geo-political market disruptions—War, trade bans, the imposition of government mandated production quotas, and similar events are beyond the control or reasonable forecasting of the taxpayer, but may significantly affect the value of IP.
- Timing issues—For many of the factors discussed above, the period of time between the controlled transaction and the occurrence of the event will bear on whether the taxpayer reasonably could have anticipated the event. In general, the ability of taxpayers to predict such events beyond the very short term—and hence the likelihood of an information asymmetry—is limited.

***Consistency of contingency clauses with Chapter I guidance on risk***

Under the guidance provided by Chapter I of the OECD guidelines, contractual allocations of risk should be respected so long as the conduct of the parties is consistent with such contractual allocations of risk. Chapter I (paragraph 1.47) notes that changes to the purported allocation of risk when risk outcomes are known is inconsistent with the arm's length principle – that principle should constrain tax authorities as well as taxpayers. The imposition by tax authorities of contingency clauses where not adopted by the taxpayer is a change to the contractual allocation of risk. The guidance should make it clear that such imposition is subject to the Chapter I guidance on delineation of transactions.

The Discussion Draft suggests that tax authorities are free, at their own discretion, to impute a form of payment for the transfer of HTVI that is different from the form of payment used by the taxpayer. The Discussion Draft provides no guidelines to limit the circumstances where such restructuring is appropriate. Example 2 (para 28) imputes a contingent true-up form of payment when only an upfront lump sum payment form was adopted by the taxpayer. The Example allows the tax authority to assess tax in Year 3 (the imputed contingent true-up payment date) when the lump sum was actually paid in Year 0 and the form of payment adopted by the taxpayer called for no payments beyond the initial lump sum. The Discussion Draft should clearly limit tax authorities' discretion to impute a different form of payment to circumstances where the taxpayer did not undertake a conscientious valuation *ex ante*. In addition to being inconsistent with the Chapter I guidance on respect for contractual risk allocations, allowing unbridled discretion on the part of tax authorities to impute a different form of payment than that of the taxpayer creates unwarranted tax uncertainty which is harmful for investment and trade.

The guidance should note that the contractual arrangements as set by the taxpayer embody certain allocations of risk among the related entities. For instance, a transaction structured as a sale of HTVI for a lump sum payment embodies different allocations of risk than another transaction structured as a sale of HTVI for a royalty on sales over a period of time. The guidance should make it clear that the imposition of contingency clauses in the determination of arm's length prices should not be used to replace a valid contractual allocation of risks by the taxpayer consistent with Chapter I with an alternative allocation determined by the tax authority.

We further recommend that the guidance make clear that the imposition of price adjustment clauses should not be used as a way to circumvent the exemptions for application of the HTVI approach. For example, suppose a taxpayer transfers a HTVI and meets the fourth exemption for application of the HTVI approach, *i.e.*, in the first five years of commercialization of a product using the HTVI, the actual results are within 20% of the financial projections. Assume further that actual outcomes are significantly higher than financial projections in the sixth year after commercialization, when a tax authority audits one of the earlier years. While the transfer involves a HTVI, the HTVI approach should not apply in this case and a tax authority should not be able to impose a contingency payment different from the taxpayer's contractual arrangement. Specifically, the tax authority should not be able to impose a contingency clause that makes payments dependent on year six or later results if the taxpayer did not contemplate such a contingency clause. While paragraphs 6.192 and 6.193 of the revised Chapter VI indicate that *ex post* evidence should not be used to impose price adjustment clauses if one of the exemptions of paragraph 6.193 applies, tax authorities will always be making their determinations in the presence of *ex post* evidence, and it is likely in practice to inform their determinations under, for example, paragraph 6.185 of Chapter VI. Therefore, we recommend that the OECD implementation guidance emphasize restraint in the use of such changes to contractual terms. In other words, the exemptions to the HTVI approach should take priority and only if none of the exemptions is met should remedies, such as price adjustment clauses, be considered.

***Clearer implementation guidance to improve consistency and reduce the risk of double taxation***

The stated goal of the implementation guidance on HTVI is to reach a common understanding and practice among tax administrations on how to apply adjustments resulting from the application of the HTVI approach. Common understanding and practice should improve consistency and reduce the risk of double taxation. While the revised Chapter VI of the OECD Transfer Pricing Guidelines provides guidance on the HTVI approach, in order to reduce the uncertainty for taxpayers and tax authorities, it is essential that tax authorities implement the HTVI approach consistently and uniformly with this guidance. Therefore, it is in turn important that the implementation guidance provide clarity on the interpretation of guidance included in Chapter VI. We believe that the Discussion Draft does not provide this clarity, particularly in articulating practical guidance regarding several issues, including:

- Chapter VI defines HTVI as intangibles for which, "at the time of their transfer between associated enterprises, (i) no reliable comparables exist, and (ii) at the time the transaction was entered into, the 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, making it difficult to predict the level of ultimate success of the intangible at the time of the transfer."[6] This definition seems particularly subjective, increasing the likelihood that tax authorities will differ on where to draw the line. It is important that tax authorities have a common understanding of what a HTVI is. If one tax authority views an intangible as a HTVI while another does not, their views on the use of *ex post* outcomes will differ and may leave them with no common ground. It would be helpful if the OECD could provide practical and balanced guidance on how a HTVI may be identified. In the absence of such guidance, it is possible that some tax authorities will default to treating any intangible that does not meet the quantitative exemptions for the application of the HTVI approach as a HTVI, while others will use more qualitative criteria leading to different conclusions on whether an intangible is a HTVI. It would be helpful if the OECD could provide practical guidance on identifying HTVI independent of the relation between actual outcomes and projections. For instance, the OECD should provide examples illustrating what it means by "reliable comparables." One example is where an intangible is acquired from a third party in a stock or asset purchase. If the intangible is then transferred intercompany, it should not be considered a HTVI given the existence of a third-party price from which the intangible value may be derived. The OECD should also provide examples of what it means by projections or assumptions being highly uncertain. One example could be where an intangible being transferred is for a commercial product for which the taxpayer has projections that it has used for investor presentations. Such an intangible should not be classified as a HTVI even if, over time, the actual outcomes are substantially different from the projections. In other words, tax authorities should not simply use hindsight to determine whether an intangible was hard to value.
- The Discussion Draft suggests imputing contingency clauses to the taxpayer's actual form of payment as a mechanism to adjust the transfer price. As discussed above, tax authorities should not

[6] Paragraph 6.189 of the OECD Guidelines.

be able to alter valid contractual arrangements in opposition to Chapter I of the OECD transfer pricing guidelines.

- Example 2 seems to imply that tax authorities can audit issues indefinitely, regardless of whether such issues have previously been audited and signed off on, or have not been audited but are otherwise statute-barred. If tax authorities are free to impute 'later in time' contingent payments when none were intended by taxpayers, significant uncertainty arises as to the close of the statute of limitations on assessment of additional tax (as is the case in Example 2 if the statute of limitations for assessment had closed for Year 0 at the time of the tax examination). In the OECD's March 2017 report on Tax Certainty (the "Report"),[7] the OECD cited "unpredictable or inconsistent treatment by the tax authority" as the second most significant contributor to tax uncertainty. The Report recommends improving clarity of tax legislation through improved tax policy and law design, including "improved clarity and reduced complexity, including avoiding inappropriate retroactivity." In accordance with the G20 and OECD's objective to improve tax certainty, the Discussion Draft should set out a framework for imputing a form of payment different than that of the taxpayer's form of payment only in circumstances where the taxpayer did not undertake a conscientious valuation on an *ex ante* basis.

  We respectfully suggest that the OECD insist on the mandatory application of domestic and treaty-based statutes of limitation and indicate that the HTVI approach must not and cannot be used to circumvent statute-barred dates. Given the substantial policy considerations that support statutes of limitations for tax assessments, we believe that the guidelines should reflect that while the returns from the intangible property for all periods may be considered as evidence in determining whether a tax authority may apply the HTVI approach, the actual adjustment should be limited to returns attributable to open tax years. Tax authorities should not be permitted to impute contingent payment arrangements as a mechanism for capturing "catch-up" adjustments relating to closed years.

- The Discussion Draft currently includes three examples which make certain assumptions related to the application of the HTVI approach. It would be helpful if the guidance included additional examples to clarify application of certain aspects of the approach instead of simply assuming them. KPMG recommends including the following additional examples in the guidance.

  - As noted above, it is important that tax authorities have a common understanding of what qualifies as HTVI, which is the very foundation of the application of the HTVI approach. It would be helpful if the OECD guidance included two examples where the quantitative exemptions for the HTVI approach are not met (*i.e.*, the actual outcomes are more than 20% different from the projections for the first five years after commercialization and the compensation based on the actual outcomes is more than 20% different from the compensation based on the projections – in addition, there is no APA covering the transaction). In one example, the tax authorities evaluate the intangible and determine that it is not a HTVI and in the other they conclude that the intangible is a HTVI.

  - It is important to have a clear standard for how a taxpayer can demonstrate that the *ex post* results and reasonably foreseeable events were appropriately considered for a HTVI at the time of the transaction to reduce uncertainty for taxpayers and tax authorities. Examples 1 and 2 of the Discussion Draft assume that the taxpayer cannot demonstrate that the actual result was due to an unforeseeable event. This wording captures the instance when the taxpayer does not meet the exemption in clause 6.193(i)(2)(a) yet fails to recognize the potential application of the exemption provided in (b) of the same paragraph. In these examples, the Discussion Draft

[7] IMF/OECD Report for the G20 Finance Ministers on Tax Certainty, March 2017.

should convey that the taxpayer in question could meet neither (a) nor (b) of the exemptions provided. That is, the Discussion Draft should state that the taxpayer was unable to demonstrate the probabilities of future outcomes were not significantly overestimated or underestimated based on evidence and experience at the time. The taxpayer's burden of proof should reflect reasonable commercial practice at the time of the transaction. *Ex-post* evidence should not be relied upon when the taxpayer sufficiently demonstrates that the actual outcomes were foreseeable and were assigned appropriate probabilities. It would be helpful if the guidance included an example illustrating how the taxpayer was able to demonstrate that: (i) an event was unforeseeable, and (ii) probabilities determined at the time of the transaction were not significantly overestimated or underestimated.

To be of greatest practical benefit this example should discuss an unforeseeable business event rather than a catastrophic natural disaster or political event that no business could reasonably be expected to anticipate. For instance, suppose the taxpayer has transferred a HTVI to a related party. In determining the arm's length transfer price it uses financial projections. These projections are created by the business development group within the company with no input from the tax department and are used by the company for various business purposes. The projections factor in two expected scenarios – a "high" scenario, which implicitly probability-weights outcomes for the company assuming commercial success, and a "low" scenario, which implicitly probability-weights outcomes for the company assuming poor commercial performance. The high and low scenarios factor in the company's judgment and expectations of numerous possible future events, such as competitor strength, new product development, consumer demand, potential government regulations, weather-related events, political environment, etc. While the company does not exhaustively tabulate every possible future event and assign a projection or probability to it, the high and low scenarios implicitly factor in positive or negative impacts of these factors on the future projections of the business. Suppose now that the HTVI does not meet any of the quantitative exemptions for application of the HTVI approach and the actual outcomes are significantly different from the *ex ante* probability-weighted high-low projections because a competitor that was developing a competing product runs into some difficulties and has to postpone the launch of its product for several years. The actual results of the taxpayer thus fall above the expected average projections in the taxpayer's "high" scenario. While the taxpayer did not explicitly develop a scenario for this particular eventuality, both its low and high forecasts do incorporate the taxpayer's business judgment on positive and negative impacts of competitor products on its business. Given the qualifications of the people creating the forecasts, *i.e.*, the business development team, the use of the forecasts in making business decisions, the nature of the forecasts as being unrelated to the HTVI transfer and the consideration of the competitive landscape in the creation of the forecasts, the taxpayer should be considered as having met the first exemption for application of HTVI approach, namely that it reasonably considered the *ex post* results at the time the transaction was entered into. Similarly, the taxpayer should be considered to have met the first exemption when it demonstrates the probabilities of the "high" and "low" scenarios were not significantly over/underestimated at the time of the transaction.

- All three examples in the Discussion Draft consider the case where actual outcomes are significantly higher than the *ex ante* projections, leading to an increase in value for the HTVI. As noted above, it would be helpful, and in keeping with the arm's length principle, if the OECD guidance were to acknowledge that there are two sides to a transaction and the HTVI approach applies equally to the buyer and seller side of the transaction. To illustrate this point, the OECD could include an example where an application of the HTVI approach leads to a reduction in the arm's length price of the transferred HTVI.

***<u>Strengthening Dispute Resolution</u>***

As noted above, from a practical standpoint, much of the challenge with HTVI is the uncertainty created for taxpayers and tax authorities. This uncertainty reinforces the importance of the OECD's work on Tax Certainty and making dispute resolution mechanisms more efficient. The OECD could help reduce uncertainty for taxpayers and tax authorities by encouraging early identification of issues and effective resolution of disputes once they do arise to ensure the avoidance of double taxation. The following are some recommendations for meeting these goals.

- Per the Chapter VI guidance, the HTVI approach will not apply if the transfer of the HTVI is covered by a bilateral or multilateral APA for the period in question. The Chapter VI guidance, thus, acknowledges the usefulness of APAs in dealing with the information asymmetry problem associated with HTVI. The OECD implementation guidance could emphasize and promote the use of APAs for transfers of HTVI. In particular, the OECD could include some structure around the use of APAs for HTVI. For instance, if the parties to the HTVI transaction operate in jurisdictions covered by a tax treaty, then the guidance could encourage the relevant tax authorities to agree early on (i) whether the transferred intangible is a HTVI and (ii) discuss the possibility of an APA. At a minimum, that might help convince some reluctant tax authorities of the need to accept such transactions as part of their APA programs. Further, the MAP Peer Review and Monitoring Process (discussed further below) should be used to ensure that tax authorities are not excluding HTVI transactions from APAs when requested by taxpayers.

- A significant tax uncertainty that must be addressed with the HTVI approach is the risk of double taxation. This uncertainty is primarily presented in cases where the HTVI approach is used to assess tax in the jurisdiction of the transferor for years that are closed for purposes of adjusting taxable income in the jurisdiction of the transferee. The Discussion Draft encourages countries to try to resolve this double taxation concern through the MAP process of applicable treaties. This is a critically significant point but is only presented in a footnote (footnote 1). We recommend that this point be included in the body of the Discussion Draft with a significant emphasis for countries to take measures to resolve the risk of double taxation. The Discussion Draft should consider adopting the following recommendations:

    - Affirm that the minimum standards of the MAP Peer Review and Monitoring Process under BEPS Action 14 that requires countries to take measures to eliminate double taxation are critically important for HTVI cases and that the MAP Peer Review minimum standards must be applied in such a way as to address the complexities of HTVI MAP cases. The Terms of Reference of the MAP Peer Review note that the OECD Model Treaty contains provisions designed to protect against double taxation in MAP cases.[8] Article 25(2) of the OECD Model states, "Any agreement [under mutual agreement procedures] reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States." The US Model Treaty contains similar, but more liberal, language, "Any agreement reached shall be implemented notwithstanding any time limits *<u>or other procedural limitations</u>* in the domestic law of the Contracting States."[9] (Emphasis added). This more expanded language helps ensure that even procedural barriers may be overridden by the MAP process to avoid double taxation.

    - The Discussion Draft should recommend that countries adopt administrative procedures to allow taxpayers to take preventative measures where the MAP treaty provisions are insufficient to override domestic laws barring a claim for refund or credit. For example, the United States

[8] BEPS Action 14 on More Effective Dispute Resolution Mechanisms, II.D, para 17 (October 2016).

[9] U.S. Model Tax Convention, Article 25(2).

has adopted administrative measures that allow taxpayers to file early protective claims for refund,[10] and provides for access to MAP even where the tax results of the transaction were previously resolved through tax authority administrative review (e.g., a closing agreement has been entered into) or judicial ruling.[11]

  - HTVI may be amortized over multiple years in the buyer's jurisdiction giving the buyer's tax authority a multiple-year window of time over which to audit the HTVI transaction and adjust the price. On the other hand, the statute of limitations on the seller's side of the transaction may end earlier. Thus, there may be a mismatch in the timing of audits or statutes of limitation in the buyer's and seller's jurisdictions. The guidance should make it clear that a mismatch in statutes of limitation in the buyer's and seller's jurisdictions related to a transfer of HTVI should not restrict a taxpayer's access to MAP.

- An emerging trend in the management of disputes around the world is the joint audit of a taxpayer by multiple tax authorities. A joint audit may have the benefit of saving resources for both the taxpayer and tax authorities, and of potentially resolving disputes before they flare up. Given the predisposition of HTVI for disputes, the OECD could encourage the joint audit of HTVI transfers where the parties to the transfer reside in jurisdictions covered by a tax treaty.

**About KPMG**

KPMG is a global network of professional services firms providing Audit, Tax and Advisory services. We operate in 152 countries and have 189,000 people working in member firms around the world. The independent member firms of the KPMG network are affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. Each KPMG firm is a legally distinct and separate entity and describes itself as such.

[10] Revenue Procedure 2015-40, Section 11.

[11] Id., Sections 6.03(2) and 6.05(2) respectively.

**Date**: June 26, 2017

**To**: Whom It May Concern

**From**: David R. Jarczyk, ktMINE, CEO

John J. Wiora, ktMINE, Director

**Subject**: Comments Regarding: Implementation Guidance on Hard-to-Value Intangibles

---

The Public Discussion Draft on BEPS Action 8: Implementation Guidance on Hard-to-Value Intangibles highlights the importance of having access to better and more timely information. Taxpayers, consultants, economists, and tax administrations need access to relevant and valuable information with regard to the intangibles of companies.

The discussion draft states that

"Tackling information asymmetry between the extensive information available to the taxpayer and the absence of information available to the tax administration, other than what the taxpayer may present, is at the heart of the reason for HTVI guidance in Section D.4 of Chapter VI of the Guidelines. Compared to the tax administration, the taxpayer is likely to have more information that can be used to create a valuation report at the time of the transaction that appears comprehensive and robust. The problem for tax administrations is that the valuation is extremely difficult to objectively evaluate since it may be wholly based on the information provided by the taxpayer. Such information asymmetry restricts the ability of tax administrations to establish or verify developments or events that might be considered relevant for the pricing of a transaction involving the transfer of intangibles or rights in intangibles, as well as the extent to which the occurrence of such developments or events, or the direction they take, might have been foreseen or reasonably foreseeable at the time the transaction was entered into."

However, the discussion draft itself does not offer solutions to improve or limit the "information asymmetry" for the tax administrations. Below we provide information on the availability of market data for transfer pricing purposes.

**Movement of Intangibles between Related Entities**

While historically tax administrations have relied upon taxpayers to provide information when the economic ownership of intangibles has shifted between related entities, tax administrations have the ability to identify these transfers and movements as part of their independent research activities on their audit targets.

Global Patent and Trademark Offices require that when legal ownership of an intangible asset is transferred they must update the ownership with the tax authority. While legal ownership does not always mean economic ownership, this information, as described below in Example 1, can help limit the "information asymmetry" between tax administrations and tax payers.

*Example 1: Movement of Intangibles between Related Entities*

A tax administration researching a company, such as Blackberry Corporation, would find that since 2013, Blackberry Corporation, a US corporation, transferred or assigned the legal ownership of over 60 patents to Blackberry Ltd., a Canadian corporation. This information enables professionals to ask certain questions, such as:

- Since the legal ownership has transferred, has there been a change to the economic owner of the intangibles?
- Was the transfer part of a new cost sharing arrangement?
- Was there an intercompany purchase agreement for the intangibles drafted to support the transaction?
- What compensation was paid to the US Corporation for the transfer of the legal ownership of the intangible?

**Merger & Acquisition Activities**

Many government registries, regulatory authorities, and stock exchanges require firms to notify and disclose when they are acquiring or divesting a company. These transactions signal changes in corporate structures and impact the tax structures of corporations. Identifying these transactions gives tax administrations quick access to the information needed to ask the right questions in preparation for audits and mitigates the "information asymmetry."

*Example 2: Merger & Acquisition Activities*

A tax administration researching a company such as Qualcomm can identify that Qualcomm, a US corporation, has agreed to the acquisition and merger of NXP Semiconductor, a Dutch corporation. While it may take years for a transaction to affect the tax structure of a corporation, such knowledge prepares the tax administration to be proactive, ask the appropriate questions, and improve the timeliness of requesting needed information from a taxpayer. This information provides tax administrations the ability to ask the following questions:

- As part of this transaction, have new intercompany agreements been entered into?
- Have new intercompany transactions occurred, and at what volume?
- Who is the new economic owner of the IP that existed prior to the transaction?
- Who will be the economic owner of the future IP developed?

**Inventory a Company's Agreements**

While most tax administrations and consultants rely on a taxpayer's tax department to provide them with all relevant agreements a company has in order to benchmark their transactions, many times those departments do not have access to all of the relevant information, or their legal department fails to produce the most appropriate set of information. The ability to access publically available sets of agreements for taxpayers enable tax administrations to further limit the "information asymmetry."

Agreements are available for public and private companies; this information contains valuable information for tax administrations to understand the structure of transactions, the value of IP, and potential intercompany agreements that are available in the public domain.

*Example 3: Inventory a Company's Agreements*

When a tax administration looks at a company such as Alphabet, Inc., they can identify that Alphabet, Inc. owns over 330 entities, including Google Inc. and Nest Inc. Alphabet and its subsidiaries have over 120 public agreements that can be used to assist pre-audit and during audits to ensure that transactions have occurred at arm's length. Having access to this information sooner enables tax authorities to ask about third party transactions, such as arrangements between Google Inc. and America Online Inc., to see how that contract is structured and how it might be used to benchmark intercompany transactions.

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Mr. J. VanderWolk
Tax Treaties, Transfer Pricing and Financial Transactions Division
OECD/CTPA

FROM Mr P.W.H. Lankhorst / Mrs L.G.C. Sahin / Mr J.K.H. van Dam - Loyens & Loeff N.V.
REFERENCE 24810118
DATE 30 June 2017

RE Comments Loyens & Loeff on Public Discussion Draft on Hard-to-Value Intangibles

Dear Mr. VanderWolk,

In response to the invitation of the OECD to interested parties to provide comments on the public discussion draft of 23 May 2017 on “BEPS Action 8: Implementation Guidance on Hard-to-Value Intangibles” (the “Discussion Draft”), please find in this letter the comments on the Discussion Draft on behalf of Loyens & Loeff N.V.[1] (“Loyens & Loeff”, “we” or derivative terms).

Loyens & Loeff appreciates the work done by the OECD in developing Section D.4 of the Revised Chapter VI of the OECD Transfer Pricing Guidelines. We have examined with great interest the proposed implementation guidance, and we welcome the opportunity to submit comments on the Discussion Draft.

The comments we provide in this letter are our own comments as tax professionals. They do not represent the comments of particular clients.

***General impression***

We appreciate the effort of the OECD to tackle the issue of information asymmetry between taxpayers and tax administrations in cases involving the valuation of Hard-to-Value Intangibles. Valuation in case of uncertainty requires best effort estimations of projected income and other variables. Tax administrations may have difficulties in verifying the accuracy of such projections if there is no publicly available information to support the projections. In such cases, being able to rely on *ex post* information is in our view a helpful tool for tax administrations to identify valuations to which they could pay more attention, provided that:

[1] *As a leading firm, Loyens & Loeff is the natural choice for a legal and tax partner if you do business in or from the Netherlands, Belgium, Luxembourg, and Switzerland our home markets. You can count on personal advice from any of our 900 advisers based in one of our offices in the Benelux or in key financial centres around the world. Thanks to our full-service practice, specific sector experience and thorough understanding of the market, our advisers comprehend exactly what you need.*

i. The fact that the future is uncertain is respected: if actuals deviate from projections, this should only be seen as an indication that further analysis may be required and should by no means be seen as evidence that the valuation is incorrect.

ii. If a taxpayer prepared a solid valuation and can demonstrate that the assumptions used in the valuation are plausible, the valuation should in principle be respected.

To further improve the implementation guidance, we list our suggestions to the Discussion Draft below.

***Suggestions***

We have three suggestions to improve the Discussion Draft, being:

i. Clarify that the Mutual Agreement should be applied on a per country basis

ii. Clarify in which cases a modification of the payment form may be applied

iii. Include a safe harbour for intangibles with a relatively low value.

Below we further elaborate on our suggestions.

*i. Clarify that the Mutual Agreement should be applied on a per country basis*

A very important part of the Discussion Draft is the part on the application of Mutual Agreement Procedures ("MAP") under applicable tax treaties. Adjustments to valuations of intangibles should be applied on both sides of a transaction to avoid double taxation. In this regard, we see a concurrence between the application of a MAP and the margin of appreciation of 20% as included in paragraph 6.193 of the OECD Transfer Pricing Guidelines.[2] Let us explain this with an example. If an intangible is transferred from a party in Country A to more than one acquirer (one in Country B and one in Country C), the actuals may deviate less than 20% from the projections in Country B, while the overall projections deviate more than 20% due to substantial deviations in Country C. The tax administration in Country A may take the position that a price adjustment should be made, while the tax administration of Country B will not follow such an adjustment, since the deviation is less than 20%. We recommend clarifying that tax administrations should apply the 20% deviation on a per country basis to avoid double taxation this may otherwise cause.

*ii. Clarify in which cases a modification of the payment form may be applied*

The Discussion Draft gives an example where the original purchase price of an intangible is adjusted in Year 0 (Example 1 – Scenario A) and an example where a price adjustment clause can be "imputed" by the tax administration which results in a price correction in a later year (Example 2).

2 As they read after implementation of BEPS Actions 8-10.

In Example 2 the adjustment is made in a later year, because this is “common in the [pharmaceutical] sector”. The example later clarifies that it does not intend to imply that “modification of the payment form can only occur when there is a common practice in the relevant business sector”. The Discussion Draft does not clarify whether this means that tax administrations have the liberty to choose any correction form they want (e.g. lump-sum vs contingent payments or lump-sum vs royalties payment as in Example 3). We recommend clarifying the boundaries to which tax administrations are held. Since the guidance on Hard-to-Value Intangibles is presented as an “approach consistent with the arm’s length principle”, we recommend aligning the boundaries with what is agreed upon between third parties (i.e. what is common practice in the relevant industry).

*iii.* Safe harbour

We expect that the existing guidance on Hard-to-Value Intangibles creates a large administrative burden for taxpayers performing transactions involving intangibles. For example, taxpayers are to document carefully how the pricing of the transfer of an intangible has been established, which risks have been identified, and how these risks have been quantified. This requires for example cash flow analysis and simulations.

Based thereon, we suggest including a safe harbour rule in the Discussion Draft for situations where a cost-benefit analysis indicates that the additional tax revenue that would be collected does not justify the costs and administrative burdens of avoiding the application of the guidance on Hard-to-Value Intangibles.

Yours sincerely,
Loyens & Loeff

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Milan, 30 June 2017

Via e-mail: TransferPricing@oecd.org

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**Comments on the Public Discussion Draft on BEPS Action 8: Implementation Guidance on Hard-to-Value Intangibles**

Dear Sirs,

First of all we would like to thank you for the exceptional work and results developed in the subject of transfer pricing within the BEPS project and for the opportunity to submit our comments on the Public Discussion Draft on BEPS "Action 8: Implementation Guidance on Hard-to-Value Intangibles" released on 23 May 2017 ("**Discussion Draft**").

While we acknowledge that the main goal of the Discussion Draft is to present a number of examples aimed at illustrating the practical implementation of the approach suggested by the OECD in Action 8-10 with reference to Hard-to-Value Intangibles[1] ("**HTVI**"), we believe that such document, aside to setting out the scope of application of the HTVI approach, should also lay down clear boundaries to the discretionality of

[1] OECD, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10: 2015 Final Reports*, OECD/G20 Base Erosion and Profit Shifting Project (Paris: OECD Publishing, 2015), pp. 110-112.

tax administrations in order to avoid that an excessive use of the HTVI approach could be detrimental to the certainty of transactions.

## 1. Burden of Proof

In all examples, the Discussion Draft assumes that the taxpayer cannot demonstrate that *(i)* its original valuation "*properly took into account*" certain possible developments or events and *(ii)* such developments or events were unforeseeable (paragraphs 19 and 24 of the Discussion Draft). In this respect it would be extremely useful that the Discussion Draft could also provide guidance for tax administrations (and therefore also for taxpayers) on the perimeter of the burden of proof that is placed on taxpayers.

More in detail, it should be clarified which is the minimum set of information that taxpayers should be required to prepare in order to meet the burden of proof. For instance, it should be clarified if, and to what extent, the information provided within the framework of transfer pricing documentation (Master file and Local file) set forth by BEPS Action 13[2] is considered to be sufficient.

Moreover, the examples do not provide any recommendations to tax administrations on how to distinguish between taxpayers' analyses that "*properly took into account*" possible developments/events and taxpayers' analyses that did not. In our opinion, this could create an unbalanced distribution of the burden of proof between taxpayers and tax administrations. Indeed, while on the one hand tax administrations should encounter few difficulties in challenging the appropriateness of an analysis based on an *ex post* review – also considering the several factors that have to be taken into account in performing such analysis – on the other hand taxpayers might be required to provide an evidence that is far from being straightforward (namely the proof that, at the time of performing the valuation, the evolutions had been properly taken into account or were unforeseeable).

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[2] OECD, *Transfer Pricing Documentation and Country-by-Country Reporting, Action 13: 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (Paris: OECD Publishing, 2015).

In our opinion, it should be clarified in the Discussion Draft that the burden of proof is considered to be satisfied by the taxpayer (*i.e.* the evolutions have been "*properly taken into account*") when, within the context of the above mentioned transfer pricing documentation or in a separate analysis, the evaluation of the possible scenarios contemplated also the evolutions that actually took place with a reasoned clarification of why such scenarios were considered as unlikely or with a low probability.

## 2. Re-Assessment of the Pricing Arrangements

The Discussion Draft contains examples of cases where in an audit conducted some years after a transfer of an HTVI the tax administration might argue that the price applied to the HTVI should have been different and therefore raises an adjustment. For instance, Example 2 of the Discussion Draft (paragraphs 24-29) assumes that during Year 7 the tax administration audits Company A for Years 3-5 and finds out that in Years 5 and 6 the sales of the product to which the HTVI relates were significantly higher than those anticipated. In accordance with the circumstances and the facts of the example, the tax administration might be entitled to make an adjustment to assess additional profits for the seller through either *(i)* a re-assessment of the price paid in Year 0 or *(ii)* a modification of the payment structure. In particular, Example 2 indicates that the latter could consist, based on the common practice in the relevant business sector, in an additional contingent payment triggered by the realization of a particular event (*i.e.* the earlier obtaining of the first market approval).

Here, the Discussion Draft seems to give tax administrations a wide discretion to freely adjust not only the price of the HTVI but also the (contractual) structure of intercompany pricing arrangements. In our opinion, the Discussion Draft should clarify that tax administrations should determine whether the prices applied in the controlled transactions satisfy the arm's length principle but should limit their interference on the taxpayers' flexibility in setting pricing arrangements to the exceptional circumstances where a transaction meets the conditions to be recharacterized[3].

Moreover, the discretion apparently attributed to tax administrations would have the effect of letting them arbitrarily choose a modification of the payment structure when a re-assessment of the original price is no longer possible because the tax year in which the transaction took place is barred by the statute of limitations. Indeed, in the mentioned example, the tax administration, by carrying out an audit in Year 7, would not be able in most countries to directly re-assess the price paid in Year 0 due to the applicable statute of limitations. A modification of the payment structure could therefore represent for tax administrations a specious way to make transfer pricing assessments even for years that are no longer open for assessment (regardless of the common practice on the structure of pricing arrangements in the relevant business sector). In our opinion, this approach would be in contrast with the same purposes of the rules governing the statute of limitations (which are aimed at granting certainty in all tax relationships) and should be discouraged.

## 3. Need to Factor in the Impact of the Subsequent Behavior of the Purchaser

The Discussion Draft apparently does not take into account the effects of the subsequent behavior of the purchaser. Indeed, the actions undertaken by the purchaser after the acquisition of the HTVI may have a strong impact on the development of the intangible and on the revenues (or the timing thereof) derived from the subsequent exploitation. For example, the purchaser might increase or accelerate its investment efforts in research activities due to factors that are not under the sphere of influence of the seller (e.g. a change in strategy of the purchaser following the failure of another research program). Therefore, it should be explicitly confirmed

[3] See paragraph 16 of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (approved by the OECD on 22 July 2010), which provides that "*Tax administrations are encouraged to take into account the taxpayer's commercial judgement about the application of the arm's length principle in their examination practices and to undertake their analyses of transfer pricing from that perspective*".

that the above circumstances, which might well lead to a deviation from the original business plan, would hardly be foreseeable at the time of the valuation and, in any case, would not be taken into account in transactions concluded between third parties.

## 4. Recognition of Downward Adjustments

The Discussion Draft only provides examples where *ex post* outcomes are used by tax administrations of the State of the seller in order to carry out upward adjustments. However, considering the complexity and uncertainty of HTVI valuations, both upward and downward adjustments should be considered by tax administrations. We therefore suggest to provide additional examples regarding the use of *ex post* outcomes in order to assess a downward adjustment and to encourage OECD member countries to enact downward adjustments rules in their domestic legislation in case of HTVI transactions.

## 5. Reiterated Tax Audits of the Same HTVI Transaction

As a final remark, we highlight that the examples provided by the Discussion Draft seem to allow tax administrations to recurrently carry out audits on the same HTVI transaction on the basis of *ex post* outcomes progressively arising year by year. For example, under the facts described in paragraphs 17-18 of the Discussion Draft, the tax administration might initially adjust the price of the HTVI based on an audit carried out in Year 3 and, subsequently, adjust the overall pricing structure of the same HTVI transaction requiring a lump sum payment in Year 4 based on further *ex post* outcomes arising during an audit in Year 5 (which were not available during the previous audit). This creates a distortion that is contrary to the rationale of the HTVI approach and would expose taxpayers to the risk of an open-ended uncertainty on these transactions.

***

Please feel free to contact us at TP@maisto.it with any questions or comments concerning this letter.

Sincerely yours,

Maisto e Associati

23 June 2017

Mr. Jefferson VanderWolk
Head of the Tax Treaty, Transfer Pricing and Financial Transactions Division
Centre for Tax Policy and Administration
Organisation for Economic Co-Operation and Development
2, rue André Pascal
75775 Paris Cedex 16
France

**Re: Public Discussion Draft, Base Erosion and Profit Shifting (BEPS), Action 8, Implementation Guidance on Hard-to-Value Intangibles, 23 May – 30 June 2017**

Dear Mr. VanderWolk,

I am a Chartered Professional Accountant (CPA, CA) and Chartered Business Valuator (CBV) who has specialized in transfer pricing since 1996, an expert witness in the Tax Court of Canada, and founder of MDW Consulting Inc., an independent firm that specializes in transfer pricing.

Enclosed are my comments on the Discussion Draft issued by the OECD on 23 May 2017 for guidance on the implementation of the approach for pricing hard-to-value intangibles (HTVI).

Please contact me if you wish to discuss my comments in further detail.

Sincerely,

Matthew Wall

Matthew Wall CPA, CA, CBV

Cc: Michael McDonald, Chair of Working Party No. 6

## Introduction

Just as a “picture is worth a thousand words”, the Examples in paras. 17 to 30 help explain the technical issues, audit concerns and guidance in paras. 1 to 16 of the Discussion Draft.

However, I found myself re-reading the Examples to identify and distinguish specific details for: ex ante facts; key assumptions relied upon by the taxpayer; ex post facts; presumptive evidence relied upon by the tax administration; and, available exemptions in para. 6.193 of the OECD Guidelines; to assess if the taxpayer’s price for transferring HTVI should be accepted or adjusted.

More importantly, while doing this, I recognized a process or flow chart that might help taxpayers and tax administrations review ex post facts in order to assess if there is a potential audit issue for HTVI and what the next steps might be before accepting or adjusting the transfer price for HTVI.

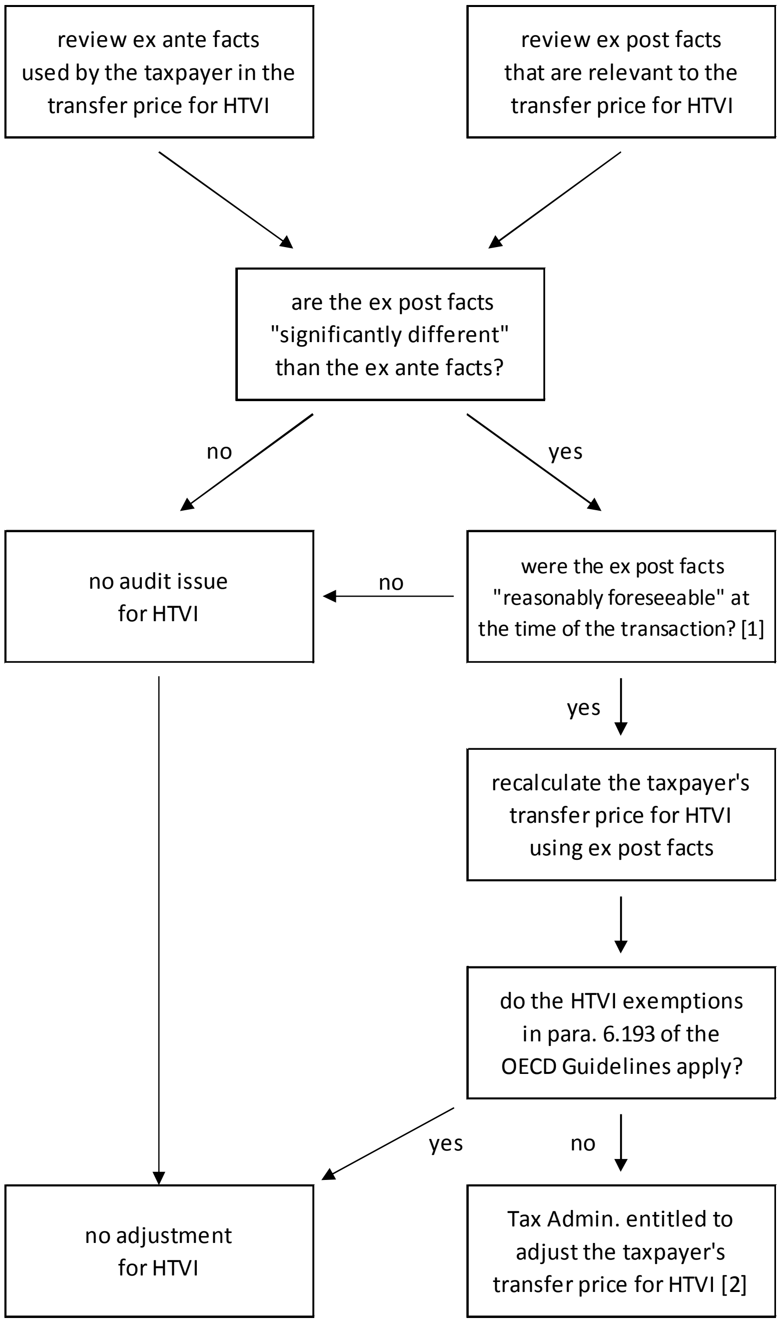
Finally, this helped identify aspects of the Discussion Draft that require further consideration.

Please review and consider the following:

- Flow chart on page 3 for assessing the transfer price for HTVI.
- Specific issues for HTVI on pages 4 and 5 that are often disputed.
- Revisions to Example 1 on page 6 that are used in the flow chart on page 7.
- Revisions to Example 2 on page 8 that are used in the flow chart on page 9.

# Flow Chart for assessing the transfer price for HTVI

The following illustrates the guidance for pricing the transfer of hard-to-value intangibles (HTVI) provided in the OECD Discussion Draft issued on 23 May 2017.




[1] Documenting the reasons why ex post results were reasonably foreseeable supports the "presumptive evidence" unless proven to be false or outweighed by rebuttal evidence.

[2] Check that the adjustment is within the normal reassessment period.

## Specific Issues

### Significant Difference

It would improve the Discussion Draft if it included the meaning of "significant" in order for the taxpayer and tax administration to mutually recognize a potential audit issue for HTVI when there is a "significant difference" between the ex post vs. ex ante facts used to price the transfer of HTVI.

To avoid a lengthy discussion, it might be sufficient to define this for pricing the transfer of HTVI as "any significant difference between the financial projections and actual outcomes that has the effect of reducing or increasing the compensation for the HTVI by more than 20% of the compensation determined at the time of the transaction" consistent with para. 6.193 (iii) of the OECD Guidelines.

### Reasonably Foreseeable

While it might be too difficult to reach consensus on a definition for "reasonably foreseeable", in its absence, it would improve the Discussion Draft to include a general list of items that the taxpayer should have on file, including items the tax administration would normally request during an audit, to establish facts that are reasonably foreseeable at the time of the transaction for pricing HTVI.

### Presumptive Evidence

It would improve the implementation guidance by including in the Discussion Draft excerpts from paras. 6.187 and 6.188 of the OECD Guidelines to:

a) encourage documenting the reasons why ex post results were reasonably foreseeable at the time of the transaction before using this as "presumptive evidence", something the tax courts might accept unless proven to be false or outweighed by rebuttal evidence; and,

b) discourage using ex post results without considering if it was reasonably foreseeable at the time of the transaction, something the tax courts consider to be inadmissible as "hindsight".[1]

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[1] See Comments submitted by Matthew Wall of MDW Consulting Inc. to the OECD on 20 August 2012 in response to the ñOECD Draft on Timing Issues Relating to Transfer Pricingò with case law on hindsight.

## Statute of Limitations

It would improve the Discussion Draft to include more guidance on the statute of limitations.

For example, the Income Tax Act in Canada allows the Minister to issue a reassessment for related party transactions within six years of the normal reassessment period and there are cases where the taxpayer challenged the Minister for issuing a reassessment after this period.

Example 2 in the Discussion Draft describes “in Year 7, the tax administration of Country A audits Company A for Years 3-5” that relies on “presumptive evidence based on the ex post outcome” before concluding “in accordance with the approach to HTVI, the tax administration is entitled to assess additional profits of 600” relating to the price for transferring HTVI in Year 0.

Effectively, the tax administration has reassessed Company A in Year 7 for a transaction in Year 0, which is beyond the normal reassessment period in Canada of six years (i.e., statute-barred).

## Comparable Circumstances

As an alternative, Example 2 would have Company A reassessed in Year 7 for a contingent payment in Year 3 based on “comparable circumstances observed in the same business sector”.

It would improve the Discussion Draft to include guidance on the standards for: comparability when using industry circumstances; substituting transactions deemed to be “economically equivalent”; recharacterizing transactions; and, related issues to consider for Example 2 and others like this.

## Concluding Remarks

As Example 2 suggests, audits involving the price for HTVI will be significant – e.g., adjusting the taxpayer’s price of 700 by nearly double to arrive at the tax administration’s price of 1,300 – and, for this reason, justifies the time needed to revise the implementation guidance for pricing HTVI.

## Example 1 – Pharmaceutical Company (revised)

The following illustration is based on paras. 17 to 23 of the guidance for pricing the transfer of hard-to-value intangibles (HTVI) provided in the OECD Discussion Draft issued on 23 May 2017.

**Co. A in Country A**

↓

**Co. S in Country S**

**Ex ante facts**

a) Co A patented a pharmaceutical compound

b) Co A concluded pre-clinical tests and Phase I and II of clinical trials

c) Year 0: Co A transferred the patent rights to an affiliate, Co S

d) Year 0: Co S paid a lump sum to Co A of 700 for the patent rights

e) Co S responsible for Phase III clinical trials

**Co A and Co S relied on the following key assumptions**

f) 700 based on an estimate of the expected income or cash flows

g) commercial sales would not commence until Year 6

h) sales would not exceed 1,000 in any year

i) discount rate based on external data for the risk of failure for drugs in a similar category and stage

---

**Ex post facts**

j) Year 4: Tax Admin A audits Co A for Years 0-2

k) Co S began commercial sales in Year 3, not Year 6

l) actual sales in Years 3 and 4 correspond to the projected sales for Years 6 and 7

**Tax Admin. relied on the following presumptive evidence**

m) Co A cannot demonstrate that the original valuation considered the possibility of earlier sales

n) Co A cannot demonstrate that earlier sales was unforseeable

o) Co A's valuation should have taken into account the possibility of earlier sales

**Reassessment - Scenario A**

p) Tax Admin A revises Co A's valuation from 700 to 1,000, an increase of 300

q) none of the exemptions for HTVI in para. 6.193 of the OECD Guidelines apply

r) Tax Admin A is entitled to reassess Co A for additional profits of 300 in Year 0

**Reassessment - Scenario B**

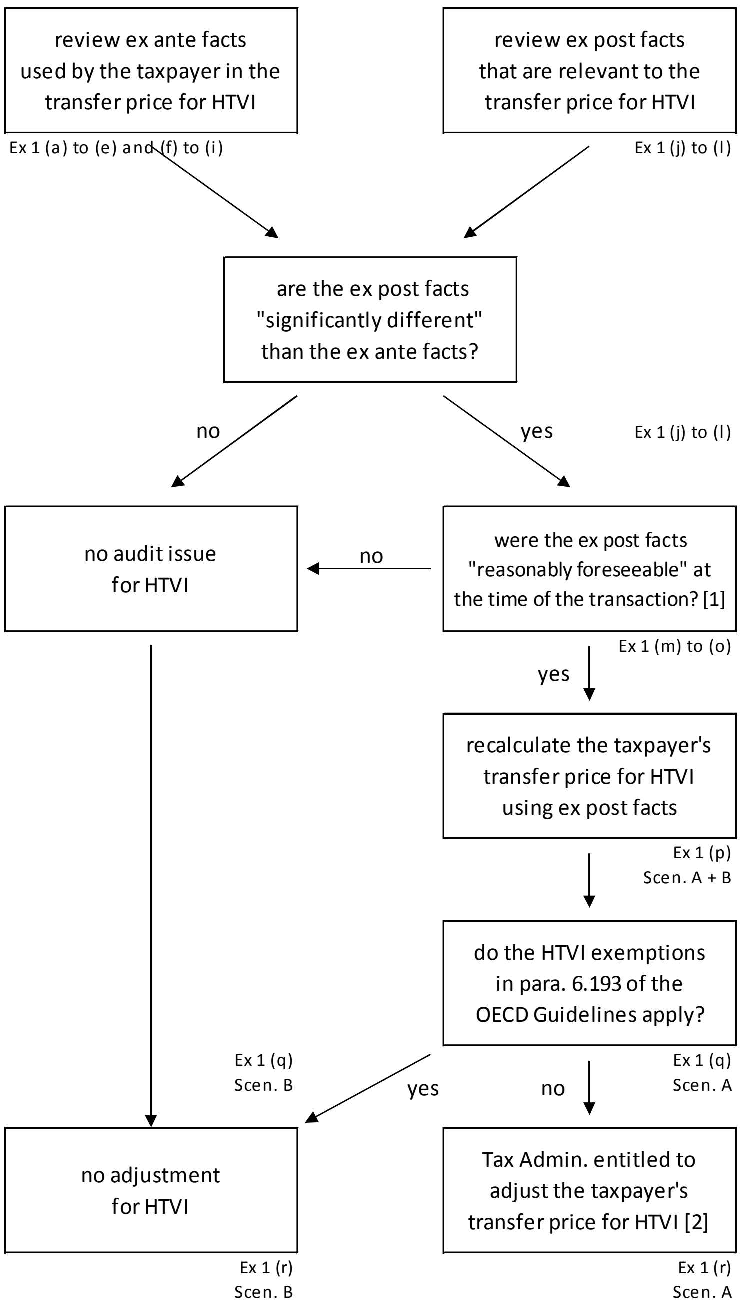
p) Tax Admin A revises Co A's valuation from 700 to 800, an increase of 100

q) one or more of the exemptions for HTVI in para. 6.193 of the OECD Guidelines apply

r) Tax Admin A might reassess Co A using other sections of the OECD Guidelines

# Flow Chart for Example 1

The following illustrates the guidance for pricing the transfer of hard-to-value intangibles (HTVI) provided in the OECD Discussion Draft issued on 23 May 2017.

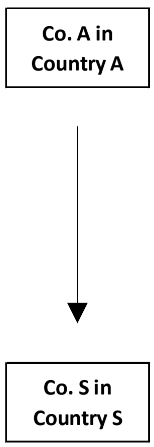



[1] Documenting the reasons why ex post results were reasonably foreseeable supports the "presumptive evidence" unless proven to be false or outweighed by rebuttal evidence.

[2] Check that the adjustment is within the normal reassessment period.

# Example 2 (revised)

The following illustration is based on paras. 17, 18 and 24 to 29 of the guidance for pricing the transfer of hard-to-value intangibles (HTVI) provided in the OECD Discussion Draft issued on 23 May 2017.




**Ex ante facts**

a) Co A patented a pharmaceutical compound

b) Co A concluded pre-clinical tests and Phase I and II of clinical trials

c) Year 0: Co A transferred the patent rights to an affiliate, Co S

d) Year 0: Co S paid a lump sum to Co A of 700 for the patent rights

e) Co S responsible for Phase III clinical trials

**Co A and Co S relied on the following key assumptions**

f) 700 based on an estimate of the expected income or cash flows

g) commercial sales would not commence until Year 6

h) sales would not exceed 1,000 in any year

i) discount rate based on external data for the risk of failure for drugs in a similar category and stage

---

**Ex post facts**

j) Year 7: Tax Admin A audits Co A for Years 3-5

k) Co S sales in Years 5 and 6 are 1,500, significantly higher than 1,000 in any year

l) actual sales of 1,500 in Years 5 and 6 do not correspond to the projected sales

**Tax Admin. relied on the following presumptive evidence**

m) Co A cannot demonstrate that the original valuation considered the possibility of higher sales

n) Co A cannot demonstrate that higher sales was unforseeable

o) Co A's valuation should have taken into account the possibility of higher sales

**Reassessment**

p) Tax Admin A revises Co A's valuation from 700 to 1,300, an increase of 600

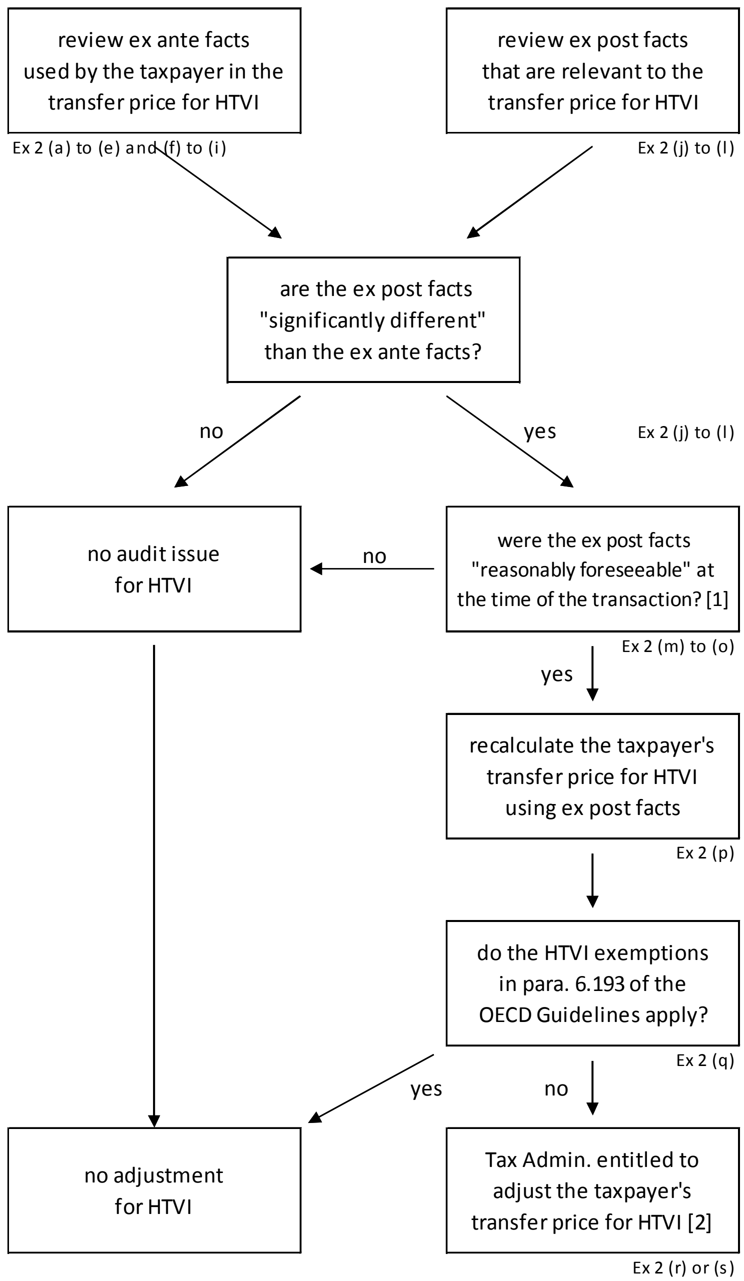
q) none of the exemptions for HTVI in para. 6.193 of the OECD Guidelines apply

r) Tax Admin A is entitled to reassess Co A for additional profits of 600 in Year 0

s) alternatively, Tax Admin A might reassess Co A for a contingent payment in Year 3

# Flow Chart for Example 2

The following illustrates the guidance for pricing the transfer of hard-to-value intangibles (HTVI) provided in the OECD Discussion Draft issued on 23 May 2017.




[1] Documenting the reasons why ex post results were reasonably foreseeable supports the "presumptive evidence" unless proven to be false or outweighed by rebuttal evidence.

[2] Check that the adjustment is within the normal reassessment period.

Organisation for Economic Cooperation and Development
Centre for Tax Policy and Administration
Attn. Jefferson VanderWolk, Head of the Tax Treaty, Transfer Pricing & Financial Transactions Division
2, Rue André Pascal
75775 Paris, France

Re: Comments on Discussion Draft on BEPS Action 8: Implementation Guidance on Hard-to-Value Intangibles

Dear Mr. VanderWolk:

The National Foreign Trade Council (the "NFTC") is pleased to provide written comments on the Discussion Draft on BEPS Action 8: Implementation Guidance on Hard-to-Value Intangibles, published May 23, 2017 (the "Discussion Draft").

The NFTC, organized in 1914, is an association of some 250 U.S. business enterprises engaged in all aspects of international trade and investment. Our membership covers the full spectrum of industrial, commercial, financial, and service activities. Our members value the work of the OECD in establishing international tax and transfer pricing norms that promote consistency for enterprises conducting cross-border operations, and we appreciate the opportunity to comment on this important project. A list of the companies comprising the NFTC's Board of Directors is attached as an Appendix.

The NFTC appreciates the opportunity to provide comments to the OECD on these important issues. In general, because the NFTC believes the use of hindsight in evaluating ex ante transfer pricing arrangements may be considered inconsistent with the arm's length principle, it should be limited to narrowly circumscribed cases. We applaud the OECD for providing some guidance with regard to the implementation and administration of the approach for HTVI. We agree, consistent with paragraph 3 of the Discussion Draft, that the objectives of such guidance should be to improve consistency with regard to the approach for HTVI, and to reduce the risk of economic double taxation.

Pre-2015 Transfers of HTVI

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Before commenting on the text of the Discussion Draft itself, we wish to reiterate our recommendation that the OECD clarify that the approach to HTVI be applied only in the case of transfers of intangibles that occur after 2015, the year in which the 2015 Final Report for Actions 8-10 was issued. The approach to HTVI introduced by the 2015 Final Report, in particular its use of hindsight to evaluate ex ante transfer pricing arrangements and its establishment of a new evidentiary standard, is an extraordinary special measure that was not contemplated by the Transfer Pricing Guidelines prior to that date. To ensure the approach operates as intended, it should be applied on a prospective basis only.

As noted in the Discussion Draft, the approach to HTVI permits tax administrations to consider ex post outcomes as presumptive evidence about the appropriateness of ex ante pricing arrangements. We agree with the Discussion Draft's clear guidance that tax administrations cannot use ex post outcomes as the basis to make an adjustment to the transaction, but rather must determine the appropriate ex ante pricing based on the information available at that time and the proper application of probability factors to expected outcomes to price the transfer. Equally important, taxpayers have the opportunity to rebut such presumptive evidence by demonstrating the reliability of the information supporting the pricing methodology adopted at the time of the transfer. This ability to rebut is critical to the operation of the approach to HTVI; without such ability, the approach would permit tax administrators to base adjustments to contemporaneous valuations on the actual profits or cash flows achieved many years later. The presumption of hindsight can be rebutted by evidence that other HTVI transfers by the taxpayer generated returns that underperformed the earlier forecast. It should be evidence of good faith valuations if the history of IP transfers average to the combined forecasts. Taxpayers should be able to use their own ex post discovery of contemporaneous facts unknown to the taxpayer at the time of pricing the transaction to support their rebuttal. Even before the rebuttal is required, taxpayers should be able to use ex post discovery of contemporaneous information, such as comparables unknown when the transaction was priced, to contest the tax administration's assertion that the transferred intangibles meet the definition HTVI.

For transfers after 2015, taxpayers are on notice with respect to the approach to HTVI. Taxpayers can ensure that valuations of HTVI are performed in a manner that takes into account the probability of a variety of outcomes, and they can document the manner in which such outcomes were considered. Alternatively, taxpayers can choose to provide for payment terms (e.g., contingent or milestone payments) that would automatically take into account actual outcomes. Such practices will better ensure appropriate results consistent with the principles of the BEPS exercise.

However, valuations of pre-2015 transactions could not have been performed in contemplation of the approach to HTVI because there was no sanctioned approach to HTVI prior to that date.

A taxpayer may have no meaningful opportunity to rebut an adjustment to a pre-2015 transfer based on ex post outcomes because that taxpayer relied on valuations and documentation that were prepared in accordance with then-prevailing standards. It is unfair to apply new evidentiary standards to transactions completed prior to the adoption of such standards. For these reasons, we recommend that the OECD clarify that the approach to HTVI be applied only in the case of transfers of intangibles that occur after 2015. The OECD should also clarify that taxpayers can use contemporaneous information discovered ex post to both contest the determination that the transferred intangibles are within the scope of the HTVI rules and to rebut the presumption in favor of the tax administration's adjustment.

<u>Example 1 – Taking into Account and Reflecting the Possibility of Outcomes, Rather than Actual Outcomes</u>

In Example 1 of the Discussion Draft, Company A transfers in Year 0 the patent rights related to a pharmaceutical compound to an affiliate for a lump sum of 700. The transfer price was determined on the basis of expected cash flows from the exploitation of the developed drug once the drug was approved for use. The discount rate was determined with reference to external data analyzing the risk of failure for similar drugs at similar stages. The taxpayer assumed that sales would not exceed 1,000 a year, and that commercialization would not commence until Year 6. In fact, commercialization started in Year 3. The last sentence of Paragraph 19 explains that the taxpayer cannot rebut the presumptive evidence from the ex post outcome in part because the taxpayer "cannot demonstrate that its original valuation <u>properly</u> took into account the possibility that sales would arise in earlier periods." (Emphasis added).

The NFTC recommends that the word "properly" be omitted from the last sentence of Paragraph 19. Under the summary facts of Example 1, it appears that the original valuation did not take into account the possibility that commercialization could commence prior to Year 6. If that is the case, then the word "properly" should be omitted. If instead Example 1 is intended as an illustration of a case in which the original valuation took into account the possibility that sales would arise in prior periods, but did not do so appropriately (for example, by assigning too low a probability to that potential outcome based on the facts known at the time of the transfer), then additional language should be added to Example 1 to lay the requisite predicate for that conclusion.

The second sentence of paragraphs 20 and 22 illustrates the approach to HTVI by providing that the "taxpayer's original valuation is revised to include earlier sales". The NFTC recommends that these sentences be clarified to provide that the original valuation is revised to include <u>the possibility of</u> earlier sales. If the actually realized earlier sales, rather than the possibility of earlier sales, were taken into account, then the present value of the transfer rights would be based solely on the actual outcome, which is inconsistent with the approach to HTVI and the guidance in the Discussion Draft. See para. 6 of the Discussion Draft ("However, it would be incorrect to base the revised valuation on the actual income or cash flows without also taking into account the probability, at the time the transaction, of the income or cash flows being achieved.") This change would bring the language in line with what we believe to be the intended application of the approach to HTVI, as well as the parallel language of paragraph 25.

Example 2 – Taking into Account the Possibility of Outcomes, and Non-recognition of Actual Payment Form

The facts of Example 2 are the same as in Example 1, except that during an audit of the taxpayer for Years 3-5, the tax administration learns that sales in each of Years 4 and 5 were 1,500. The taxpayer had not projected sales any higher than 1,000 in any year. Like Paragraph 19, the last sentence of Paragraph 24 explains that the taxpayer cannot rebut the presumptive evidence from the ex post outcome in part because the taxpayer "cannot demonstrate that its original valuation properly took into account the possibility that sales would reach these levels." (Emphasis added).

Consistent with the recommended change to Paragraph 19, the NFTC recommends that the word "properly" be omitted from the last sentence of Paragraph 19. Under the summary facts of Example 2, it appears that the original valuation did not take into account the possibility that sales could be higher than 1,000. If that is the case, then the word "properly" should be omitted. If instead Example 2 is intended as an illustration of a case in which the original valuation took into account the possibility that sales could exceed 1,000, but did not do so appropriately (for example, by assigning too low a probability to that potential outcome based on the facts known at the time of the transfer), then additional language should be added to Example 2 to lay the requisite predicate for that conclusion. An estimate of sales in a valuation typically represents the most likely outcome, or a probability-weighted average of potential outcomes, based on the facts and circumstances available at the time. It typically reflects forecasts that the business uses for commercial purposes. A valuation based on the highest foreseeable level of sales would not be reliable unless the result was heavily discounted to reflect the high probability that such sales would not be achieved.

Paragraphs 27- 29 discuss the range of potential adjustments the tax administration may make under the HTVI approach. In particular, it provides two alternatives: (1) the tax administration may re-assess the lump sum paid in Year 0, or (2) the tax administration may impose an alternative payment structure in which additional contingent payments were due upon the successful completion of development phases, and impose an additional lump sum payment in Year 3. This second alternative may be considered whether or not there is a common practice in the relevant business sector to provide for such contingent payment arrangements.

The NFTC recommends that this second alternative be reconsidered. The form of payment can be a critical element to the terns of a transaction. See paras. 6.179 and 6.180 of the OECD

Transfer Pricing Guidelines. Under the second alternative, the taxpayer's actual transaction (a transfer in exchange for a lump sum) is disregarded in favor of another, hypothetical transaction (a transfer in exchange for a lump sum and contingent payments) that is inconsistent with common practice in the relevant business sector. A tax administration may not disregard the actual transaction entered into by the taxpayer unless the exceptional circumstances of paragraphs 1.122 – 1.125 of the OECD Transfer Pricing Guidelines are met. Respect for actual transactions is critical because "non-recognition can be contentious and a source of double taxation." Paragraph 1.122. The key question in this analysis is whether the actual transaction possesses the commercial rationality of arrangements that would be agreed between unrelated parties under comparable circumstances. There is no suggestion in the Discussion Draft that this standard is met or is even being applied; indeed, paragraph 28 states that there is no intention to imply "that modification of the payment form can only occur when there is a common practice in the relevant business sector regarding the form of payment." The second alternative should either be eliminated or redrafted in light of the standard for disregarding actual transactions.

Example 3 – Adjustments with respect to Closed Years and the Mutual Agreement Procedure

The facts of Example 3 are similar to those in Example 1, except that the payment form is a periodic royalty based on a percentage of anticipated sales. The tax administration determines on an audit of Years 3-5 in Year 7 that the value of the transferred intangible was higher than that determined in the original valuation, and therefore that the royalty rate should have been higher in all years. Presumably in recognition of the fact that Years 0-2 may be closed to adjustment due to a local law statute of limitations, and the possibility that the tax administration may nevertheless attempt to make an adjustment with respect to royalties paid in closed years by imposing a "catch up" adjustment in open years, footnote 1 states the following:

> Countries may take different positions under their domestic rules relating to statutes of limitations as to whether primary and corresponding adjustments may be made during open tax years with respect to amounts that relate to closed tax years. Recognising these differences, countries should endeavor to reach agreement under the mutual agreement procedure in the relevant treaty to resolve cases of double taxation at least for open years under statute of limitation rules that would have applied if the country making the corresponding adjustment had itself made the primary adjustment. (Emphasis added.)

We appreciate that the OECD cannot dictate to countries how to structure or interpret domestic statutes of limitations. However, where a taxpayer has structured an arrangement to provide for the use of intangibles in exchange for a royalty paid each year based on sales in that year, it seems inappropriate to use the HTVI approach to permit adjustments to royalties paid in closed years. The information necessary to determine whether a royalty rate in Year 1 or Year 2 is consistent with the arm's length principle – for example, sales in each year, or licensee profitability in each year – is available as of the end of each year, and may be audited in a normal course audit of each year. The HTVI approach may be suitable for assessing whether the royalty rate applied to sales in open years is appropriate in light of ex post outcomes and the presumptions that could be drawn from such outcomes.

Moreover, in the event that a tax administration is permitted under its domestic law statute of limitations to make adjustments to open tax years with respect to amounts that relate to closed tax years, we see no reason why the treaty partner should not make a corresponding adjustment irrespective of its statute of limitation rules if it agrees with the substance of the primary adjustment. The OECD Model Tax Convention provides that any agreement reached in the mutual agreement procedure shall be implemented notwithstanding any time limits in the domestic law of the Contracting States. The Final BEPS Report for Action 14 provides that countries should either adopt this language or, as an alternative, adopt alternative language that limits the time during which a country may make a primary adjustment. See Minimum Standard 3.3. Footnote 1 appears to permit to tax administrations to disagree as to the scope of their obligations under the mutual agreement procedure in a manner that is inconsistent with the minimum standards in the Final BEPS Report for Action 14. Such inconsistency will inevitably lead to double taxation.

Accordingly, the NFTC recommends modifying and expanding the language of footnote 1 to provide a more robust discussion of the extent to which adjustments made to open years may reflect amounts that relate to closed years. This discussion should address the interpretation of bilateral tax treaties that place time restrictions on the ability of countries to make primary adjustments, consistent with the alternative language outlined in Minimum Standard 3.3 of the Final BEPS Report for Action 14. More generally, the NFTC recommends that the Discussion Draft be revised to confirm the obligation of countries to endeavor to reach agreement under the mutual agreement procedure with respect to any primary adjustment justified on the basis of the HTVI approach and permitted under the applicable tax treaty. This latter recommendation could be implemented in the context of Example 3 or in a more fulsome discussion in paragraphs 31 or 32.

Sincerely,

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Vice President for Tax Policy
National Foreign Trade Council
cschultz@nftc.org
202-887-0278 ext. 2023

## Appendix to NFTC Comments on BEPS Action 8: Implementation Guidance Hard-to-Value Intangibles

NFTC Board Member Companies:

ABB Incorporated
Amazon
Amgen
Applied Materials
Baxter International Inc.
British American Tobacco
Cargill
Caterpillar Incorporated
Chevron Corporation
Cisco Systems
Coca-Cola Company
ConocoPhillips, Inc.
Corning
Deloitte & Touche
Dentons US LLP
DHL North America
eBay, Inc.
E.I., du Pont de Nemours & Co.
Ernst & Young
ExxonMobil Corporation
FCA US LLC
Federal Express
Fluor Corporation
Ford Motor Company
General Electric Company
Google, Inc.
Halliburton Company
Hanesbrands Inc.
Hewlett-Packard Company
HP Inc
IBM Corporation
Johnson Controls
KPMG LLP
Mars Incorporated
Mayer Brown LLP
McCormick & Company, Inc.
Microsoft Corporation
Mondelez International Inc.
Oracle Corporation
Pernod Ricard USA
PMI Global Services Inc.
PricewaterhouseCoopers LLP
Procter & Gamble
Qualcomm Incorporated
Siemens Corporation
TE Connectivity
Toyota Motor Sales, USA Incorporated
United Parcel Service, Inc.
United Technologies
Visa, Inc.
Walmart Stores, Inc.

NERA
ECONOMIC CONSULTING

# Discussion Draft on the implementation guidance on hard-to-value intangibles

# Comments by NERA Economic Consulting[1]

June 30, 2017

VIA E-MAIL to TransferPricing@oecd.org

Dear Sir or Madam,

We thank you for the opportunity to provide comments on the *Implementation Guidance on Hard to Value Intangibles* released by the OECD on May 23, 2017, (the "Draft"). The comments we would like to offer for your consideration are stated below.

## 1. IP lifecycle and value

It would be quite rational to expect that when an IP in the early stages of development is valued in an arm's length setting, the value placed on such an IP would be lower than the value of the same IP in the later stages of the development.

The main reason for this is that in the early stages of development it would be natural to expect a greater variability in the profit potential of the IP than in the later stages of development. Therefore, an arm's length investor would apply a higher discount rate to value an IP in an early stage of development compared to the same IP in a later development stage.

As an example, one can consider the value of the IP embedded in a pharmaceutical product that is just entering the Phase I of clinical trials vs. the same pharmaceutical that has completed the Phase III trials and received a marketing approval. Because failures of pharmaceutical products to pass successive phases of clinical trials are not uncommon, it would be quite rational for an arm's length investor to place a lower value on the IP of the product at the time when it was entering the Phase I trials compared to the same product a few years later after it has received a marketing approval.

[1] These comments represent views of the authors and do not necessarily reflect the views of NERA Economic Consulting.

Therefore, tax authorities' position that the value of an early-stage IP has to be computed using the profitability realized in later years would be at odds with the arm's length evidence.

### 2. Contingent Payments and Adjustable Royalties

The Draft tends to view the valuation of Hard-to-Value Intangibles (HTVI) as a "one-shot deal." Although one-shot deals have their place among taxpayers in controlled relationships, such transactions may be quite rare, because most of the related-party transactions occur in the context of long-term, cooperative relationships. To understand the patterns of arm's length behavior in transactions that involve development of intangibles with uncertain value and continuous engagement of the parties, one can turn to transactions involving growth-stage companies funded by venture capital ("VC arrangements").

As mentioned in the preceding paragraph, in VC-backed deals, it is common to place a rather low value on an IP in the early rounds of investment when the profit-generating potential of the IP is associated with significant uncertainty. As the development of the IP progresses and some of the uncertainties get resolved, the value of the IP changes. Assuming a favorable resolution of the uncertainty (e.g., successful completion of a clinical study phase for a new drug, reaching of a development milestone by a software product, etc.), the value of the IP will increase. In a VC-backed transaction, this normally results in a higher valuation of the company shares in subsequent funding rounds. Often, VCs from the earlier rounds will participate in subsequent funding rounds too, meaning that they may pay a higher price for shares of the same company. This is equivalent to paying a higher price for the same IP after some of the uncertainty about the profit generating potential of this IP has been removed.

Applying the same reasoning to transfers of HTVI in controlled transactions where the value of the intangibles increases after subsequent development, an arm's length behavior for the taxpayers would be to periodically re-value the IP associated with HTVI. In practice, this could be achieved via the mechanism of contingent payments and / or variable royalties. In view of the arm's length evidence discussed above, the authors believe that the "alternative pricing structures" mentioned in para. 12 of the Draft and para. 6.192 of the *Guidelines* should be discussed as important and, sometimes, necessary attributes of transactions involving HTVI.

### 3. How significant is the information asymmetry between taxpayers and tax authorities?

In the experience of the authors, for the intangibles transferred in the early stages of development, the information asymmetry between the taxpayer and the tax authorities may not be as large as is presumed by the Draft. The main reason for this is that taxpayers in the early stages of IP development rarely have an insight into the true value of the intangibles they are developing. If the projections of cash flows from the intangibles are highly uncertain (which is the very definition of the hard-to-value intangibles proposed in paragraph 6.189), there may be a broad range of potential value outcomes for these intangibles once they are fully developed. For many types of intangibles under development the resulting value depends on the events outside of the taxpayer's control. As an example, such events may be (i) internal unanticipated events, such as delays or acceleration of the development schedule, deviation of the actual intangible development costs from the projections, changes in the scope of the development work, (ii) external unanticipated events, such as state of the market at the time of the intangibles rollout that may either be conducive or detrimental to the profits derived from the intangibles at the time or their commercialization; competitive entry during the development period that could materially reduce profitability of the intangibles under development or even render them obsolete, etc.

Thus, the Draft's presumption that the taxpayers always have more information about the true profitability of the intangibles transferred in an early stage of development leaves the taxpayer with a virtually unsurmountable burden of proof to argue that the events that led to a higher-than-expected value of the resulting intangibles were unforeseeable. Even if the value of intangibles was estimated *ex ante* by a taxpayer using a probability-weighted forecast, what is to stop a tax administration from arguing that this valuation was deliberately skewed towards a low value?

Moreover, paragraph 6.193(i) seems to imply that a taxpayer must be able to provide contemporaneous documentation from the date of transfer in order to establish an *ex post* exception based on subsequent unforeseeable developments imposes an unrealistic burden and could be viewed as foreclosing entirely reasonable *ex post* explanations that could not reasonably have been foreseen at the time of the transfer. Rather, the *ex post* exception should be based on whether or not the taxpayer can reasonably establish *ex post* that the relevant developments were unforeseeable at the time of the transfer including reference to documentation that may have been established at the time of the transfer.

## 4. False positives

The same idea can be explained with the concept of "false positives" and "false negatives," which are concepts analogous to Type I and Type II errors in statistical hypothesis testing.

In a simplified manner, a "false positive" is a result that indicates a given condition has been fulfilled, when it has not, for instance a medical test would return that a patient is infected when he is not. Conversely, a "false negative" is a result that indicates a given condition has not been fulfilled, when it has been, for instance a medical test would return that a patient is not infected when he is actually.

As an illustration, let's consider a fictive population of 1,000 persons where 2% of people are actually infected by a given disease. A test exists to perform a diagnostic. This test has a false positive rate of 5% (0.05) and no false negative rate (all infected patients are tested positive by this particular test). The expected outcome of the 1,000 tests on population would be as follows:

**Table 1: Illustration of false positive paradox**

| | | Infection actual status | | |
|---|---|---|---|---|
| | | Infected | Uninfected | total |
| Test results | Positive | 20 | 49* | 69** |
| | Negative | 0 | 931 | 931 |
| | Total | 20 | 980 | 1000 |

* Calculated as 1,000 * 98% *5%

** The sum of truly infected patients and false positives

In the above situations, the test would result in identifying 69 "positive" (i.e. infected) out of which 20 only would be true positive and 49 false positive. This example illustrates that, in certain situations, false positive tests are more probable than true positive tests (a situation referred to as the "false positive paradox").

The authors believe that the concept of false positives may be insightful when applied to the HTVI Draft. As a matter of fact, it may be extremely difficult, ex-post, to distinguish between "bad faith tax payers" who abusively mispriced the value of a transferred intangible and "good faith taxpayers" who priced the intangible earnestly but for whom exceptional circumstances arose, resulting in a substantial deviation between the initial expectations and the actual business conditions.

Another way to put it would be to consider – as an illustration – a situation where all taxpayers are acting in good faith. Let's assume that in 80% of the cases, *ex ante* and *ex post* valuation of intangibles are aligned. Yet in 20% of the cases, there is a misalignment, with 10% of the cases resulting in an overvaluation of intangibles and an over-taxation and 10% of the cases where intangibles were undervalued resulting in an insufficient taxation. [2] Under the approach recommended by the Draft, it is likely that the latter 10% cases would result in a reassessment. Yet, assuming all of the taxpayers acted in good faith, these cases would just correspond to situations where the most extreme scenarios have occurred.

As such, as economists and transfer pricing practitioners, the authors are strongly concerned that the HTVI guidance would result in a substantial proportion of "false positives" as it would be very

[2] The terms "overvaluation" and "undervaluation" here refer to the mismatch between the *ex ante* and *ex post* valuations of the transferred intangibles by more than 20%.

difficult for taxpayers to establish that they were faithful but "lucky" versus a situation where they would have been "abusive". We can envision a situation where, tax administrations, using *ex post* results, would come to a conclusion that a group of taxpayers, on average, have underestimated the value of the transferred intangibles. Yet, at the same time, it is highly unlikely that all of these taxpayers would have acted in bad faith.

The process of intangibles development is often associated with significant risks. For the taxpayer, it may be extremely difficult to determine the full extent of reasonable scenarios which may exist for an intangible, which may require complex and extensive economic analysis that not all taxpayers in all situations may afford. For instance, taxpayers may establish projections in "good faith" which turn out to be wrong for reasons outside of taxpayers' control.

In this regard, an analysis of the evolution of comparable intangibles in the past, if possible, may be an appropriate option to determine the extent of reasonable evolution scenarios.

In particular, based on their experience, the 20% threshold featured in the paragraph 6.193 of the BEPS TP Report seems rather low. The authors find it disputable that a single threshold can be applied to all types of intangibles.

As such, the authors are concerned that the HTVI framework may be exploited by tax administrations to propose reassessments for the taxpayers who acted in good faith.

## 5. Overpayment & self-adjustment

The authors also think that the Draft should address the situations of overpayment for HTVI, when the *ex post* value of intangibles turns out to be lower than the expected *ex ante* value and offer a mechanism of resolution for such cases, both from the perspective of the taxpayer and of the tax administration, particularly because paragraph 6.184 of the OECD *Guidelines* acknowledges existence of such situations, at least in the arm's length setting.

It also would be a welcome addition to the Draft to acknowledge the possibility for the taxpayer to make self-initiated adjustments when either an under-payment or an over-payment for HTVI becomes apparent to the taxpayer.

## 6. Scenario analysis

Notwithstanding the above, the author believes that the practice of preparing a scenario analysis for intangibles whose profit potential may vary greatly should be encouraged. In this regard, please refer to a publication by V. Starkov "Applying Scenario Analysis for Computing Discount Rates in Cost Sharing Arrangements," *Tax Management Transfer Pricing Report*, Bloomberg BNA, Vol. 24 No. 4 (2015).

Such scenario analysis should be properly documented in terms of developing cash flow projections for different scenarios, assigning probabilities to each scenario, calculating discount rates, etc. so as to avoid a suspicion by the tax administration that such analysis has been "skewed" by abusive taxpayers.

## 7. Comments on Examples in the Draft

As a general comment, we think that examples should be used with caution. Ideally, the guidance should be clear and sufficiently logical so as not to require any illustration through examples.

Yet, as a suggestion, the Draft should provide an example or examples where the valuation performed by a taxpayer at the time of HTVI transfer based on *ex ante* taxpayer's projections does not get adjusted by the tax authorities, and an example when it does. The Draft should clearly spell the differences in the valuation techniques used *ex ante* by taxpayers that did not lead to an adjustment and those that did.

## 8. HTVIs and MAPs

In the opinion of the authors, the HTVI framework may substantially increase the risk of double taxation. As such, we believe that any adjustment initiated by tax authorities under this framework should automatically be open to MAP proceedings.

Best regards,

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June 30, 2017

Tax Treaties, Transfer Pricing and Financial Transactions Division
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(*delivered via email*)

***BEPS Action 8—Implementation Guidance on Hard-to-Value Intangibles* (Public Discussion Draft: 23 May-30 June 2017)**, *The Approach to Hard-to-Value Intangibles: Implementation Guidance for Tax Administrations* (hereinafter, the "draft")

**Comments by Pat Breslin[1]**

Dear members of the OECD/CTPA and working parties:

Breslin Consulting would like to thank the OECD/CTPA and the corresponding division and working parties for the opportunity to comment on this very important project. Given extensive experience in areas directly relevant to the draft—both as a business executive in R&D- and technology-related finance and ventures, and as an economist and expert on related subjects—the author welcomes the OECD's continued attention to the complex subject matter addressed in the draft.

The draft addresses very valid concerns regarding the valuation of certain transfers of intangibles among affiliates of multinational enterprises that contribute to tax base erosion and profit shifting ("BEPS"). The author recognizes the draft is intended as "implementation guidance for tax administrations" and responds to the mandate for "development of transfer pricing rules or special measures for transfers of "hard-to-value" intangibles ("HTVI")." Correspondingly, as the introductory section of the draft notes, it is recognized that Section D.4 of the revised Chapter VI on intangibles is "already formally incorporated to the [OECD Transfer Pricing] Guidelines."[2]

[1] The author would like to thank Jianwen Lu and Shiyuan Zhang of Breslin Consulting, LLC for their helpful assistance, research and analysis in support of these comments.
[2] Hereinafter, "TPG" will refer to the OECD Transfer Pricing Guidelines.

As the draft demonstrates, the implementation guidance necessarily refers to relevant sections of revised Chapter VI of the TPG. Likewise, similar references will be made in these comments. Generally, however, the comments will defer discussion on sections of the revised Chapter VI, focusing first on the subject draft implementation guidance per the May 23rd request and on the examples in the draft.

In general, the draft provides very useful insight and should serve tax administrations well as they pursue common understanding of the complex issues related to the subject intangibles transactions.

In particular, the author applauds the draft's emphasis on the "appropriate weighting" of foreseeable outcomes and the use of probability-weighted analysis in evaluating whether *ex ante* projections and assumptions produce arm's length results. This properly focuses attention on how independent parties would consider a range of potential outcomes and related risks, and the key role that this practice plays in their negotiations, the expected value and form of their compensation, and other terms and provisions in their agreements.

Key issues and concepts illustrated in the draft are commonly seen in actual arm's length negotiations and agreements, based on the author's direct business experience negotiating and concluding arm's length intangibles transactions. Such issues are also prevalent among the numerous observations of arm's length transactions seen in expert and consulting contexts—based on both publicly available and confidential arm's length evidence, and across many transaction types and industries.

The draft also expounds on the important role that information asymmetry plays in supporting the need for its guidance. Information gaps experienced by tax administrations relative to taxpayers have the effect of limiting governments' ability to fully evaluate transactions—especially when the transactions took place years in advance of an audit.

In addition to this tax-related information asymmetry, the author would point out that similar issues are experienced by independent parties to arm's length transactions (*i.e.* "transaction-related" information asymmetry)—with important effects that both inform and augment some of the guidance in the draft.

For example, among the common forms of contingent arrangements in arm's length intangibles transactions are retroactive provisions allowing a licensor to conduct a "royalty audit." Thus, *ex ante,* licensors often require rights to verify the licensee's business and financial data that support the actual royalty payments—to ensure that they comply with the license payment terms and other provisions, *ex post*. In these cases, both parties recognize that access to the licensee's actual business or financial information is asymmetric—and provide *ex post* measures to overcome this, thereby allowing the licensor to adjust past royalty payments if appropriate.

In addition, the comments below will address the examples provided in the draft, which provide very helpful context to expand on points well-made in the draft and consistent with the author's experience.

The remainder of these comments will include:

- A discussion on elements of the draft that are consistent with the arm's length principle,
- Review and comments on Examples 1, 2 and 3 in the draft,
- Discussion of transfer pricing cases that illustrate BEPS and have relevance to the draft,
- Review of the sections of the revised Chapter VI of direct relevance to the draft, and
- Conclusions.

*Special Measures and the Arm's Length Principle: Co-existence or Contradiction?*

First, it is worth addressing the past concerns of some that, in general, special measures might entail overly formulaic approaches that produce outcomes inconsistent with outcomes that would result under the arm's length principle.

However, in the author's view, the draft succeeds in addressing such concerns. In fact, when applicable, the HTVI approach in the draft introduces common elements of arm's length transactions where they are absent in controlled transactions – with the potential effect of increasing consistency of outcomes with the arm's length principle relative to outcomes originally contemplated in such controlled transactions. This point will be addressed further below.

In large part, the draft augments the assertion that Section D.4 "contains an approach consistent with the arm's length principle" in helping to "determine in which situations the pricing arrangements as set…are [consistent with arm's length results] and are based on an appropriate weighting of foreseeable developments or events that are relevant," and in which situations they are not.

This focus on "appropriate weighting of foreseeable" events is appropriate—as independent parties operating at arm's length carefully consider the potential for both good and bad outcomes and the probabilities associated with such outcomes in concluding transactions.

This combined view of different outcomes—and the parties' risks associated with such outcomes—is usually reflected in the payment terms and other provisions of an agreement and thus impact its pricing structure. The frequent presence of contingent arrangements, rights and obligations, and related provisions often coincide with pricing structures that vary under different sets of outcomes, as is apparent in many arm's length contracts.

It should be noted that the contingent nature of certain payments (whether receipts or costs), while often explicit, can be implicit as well. Indeed, contract rights to terminate or renegotiate agreements—when exercised—would have the effect of altering *ex post* outcomes relative to *ex ante* projections regarding a range of cash flows related to pricing or underlying costs and obligations. Such rights also entail option value.

Additionally, the frequent occurrence of amendments to arm's length agreements often reflect the express intent of independent parties to adjust pricing after the fact, based on certain known outcomes that were not predicted in the original agreement.

It is also foreseeable that others might voice concern that the draft's approach does *not* offer "an approach consistent with the arm's length principle" in that it allows tax administrations to adjust taxpayer's pricing structures. Critics may note that application of the arm's length principle would generally recognize transactions as structured, other than in exceptional cases.

But the draft addresses whether it is through the pricing structure itself that certain controlled transactions fail to consider foreseeable events that independent parties would have considered and factored into their agreement and pricing.

Consistent with the TPG more broadly, in effect the draft appears to consider that in controlled transactions, the contract and the conduct of the parties should be consistent—and should reflect the parties' functions, assets and risks and their capacity to undertake or assume them.

Similarly, at arm's length, contract terms and pricing structures reflect the functions, assets and risks of the transacting parties. A contingent milestone payment for successful completion of a development stage aligns the risk and the return of the receiving party with its capability to perform the related R&D and assume related risks. It also reduces the risk of the payor when it has no (or less) ability to affect the outcome. (Paragraph 12, and 27 to 29 under Example 2 provide helpful discussion regarding such alternative payment structures.)

Whatever the probability of a successful development outcome, it is uncertain and there is risk. Thus, it behooves the parties to each make their own predictions as to the likely outcome. The contract will often allocate the risk through payment terms—though both parties may continue to assume relevant or related risks in a larger sense (*e.g.* a party cannot sell a product when its counterparty supplier cannot successfully develop it).

Thus, the draft properly recognizes that a one-time, upfront lump sum payment—while it may (or may not) properly weigh this probability *ex ante*—is less able to align risk and return according to the capabilities, roles and risks of the relevant parties.

In this way, contractual terms and provisions—including pricing structures—often embody key elements and information regarding the functions, assets and risks of the transacting parties. Contracts also reflect key facts and circumstances underlying a transaction—and how the parties react and are compensated under the same or similar conditions. In important respects, the approach in the draft reinforces, rather than departs from, these core attributes of proper arm's length analysis.

*Examples*

The draft and its examples help demonstrate the effects and relevance of a common practice in business decision making—probability-weighted analysis—and its effects on outcomes under arm's length conditions.

In Example 1, Company A transfers its rights to develop and commercialize a patented pharmaceutical compound to Company S for an *ex ante* lump sum payment of 700, based on assumptions that include projected sales that commence in Year 6. The effect of this payment structure is to fix Company A's compensation and limit the potential for A to realize an increase (or decrease) in compensation in the event of a shorter (or longer) lag in developing and commercializing the drug, or its having greater (less) success in the market. This structure also limits the downside risk for Company A if Company S fails in obtaining Phase III approval and/or its actual sales fall short of projections—placing more risk on Company S in this regard.

In Scenario A of Example 1, we see that, *ex post*, sales actually commence in Year 3—reflecting considerable success that increases the expected value of the transferred intangibles from an *ex ante* net present value (NPV) of 700 to 1000, when one revises the NPV calculations to take the earlier sales into account. Despite the actual outcome, the taxpayer "cannot demonstrate that its original valuation properly took into account the possibility" of a more rapid path to commercialization, and cannot demonstrate that this possibility was unforeseeable. At arm's length, Company A would note this departure from Company S' original sales projections and its downward effect on its own compensation.

In effect, the draft properly calls to question whether actual outcomes can be claimed as "unforeseeable"—and rightfully so, as this suggests that what actually occurs is outside the realm of what was believed possible in the eyes of the parties. It similarly addresses actual outcomes that were thought highly unlikely *ex ante* as improbable *ex ante*—with sufficient flexibility to taxpayers to rebut these presumptions when they in fact are incorrect.

For purposes of the draft, Example 1, Scenario A does not provide substantial detail regarding the "appropriate weighting" of the actual outcome in a revised valuation that includes the earlier sales. Nevertheless, a simple, stylized version of such a probability weighted calculation may be useful for discussion. Such a calculation could consider two potential outcomes—1) the original taxpayer valuation with an NPV of 700, assuming sales beginning in Year 6, and 2) the actual outcome based on earlier sales beginning in Year 3.

For simplicity, here we can assume that these are the only two potential outcomes, and that the taxpayer position (*i.e.* its original *ex ante* valuation) was twice as likely as the actual outcome—that is, *ex ante* there was a 67 percent chance that the scenario with sales beginning in Year 6 would occur, and a 33 percent chance that the actual outcome would occur.

In such a case, if the probability-weighted NPV should have been 1000 at arm's length (per paragraph 20, Scenario A), the present value of the actual outcome, taken alone, would imply an *ex ante* valuation of about 1600. That is,

$$( NPV_1 * .67 ) + ( NPV_2 * .33 ) = 1000 \qquad \text{(equation 1)}$$
$$( 700 * .67 ) + ( NPV_2 * .33 ) = 1000$$
$$( NPV_2 * .33 ) = 1000 - 470$$
$$NPV_2 = 530 / .33$$
$$NPV_2 = 1609$$

Given the assumptions in the simplified probability weighted example shown above, the actual outcome in Example 1, Scenario A is approximately 2.3 times the taxpayer position (1600 / 700 ). But, as is well-noted in the draft (*e.g.* paragraph 6), "[It] would be incorrect to base the revised valuation on the actual income or cash flows without also taking into account the probability, at the time of the transaction of the income or cash flows being achieved."

Here instead, the presumptive evidence provided by the actual outcome is assumed to have a 33 percent probability of occurring, with the effect that the revised NPV is 1000, given the probability weighted analysis, and the assumptions in the draft and those given above. Thus, the position of the tax administration ("government") is 1.43 times the taxpayer's original valuation ( 1000 / 700 ).

Example 1, Scenario B follows the same assumptions in Scenario A, except that the arm's length price anticipated in Year 0 should have been 800 instead of 700, when taking into account the earlier sales beginning in Year 3. In this case, the revised valuation would yield a multiple of 1.14 (800/700) relative to the taxpayer position—demonstrating the third exemption (iii) in paragraph 6.193 of the TPG. That is, the draft's HTVI approach does not apply when the following of four exemptions apply (other exemptions will be discussed later in the comments):

> iii) Any significant difference between the financial projections and actual outcomes…does not have the effect of reducing or increasing the compensation for the HTVI by more than 20% of the compensation determined at the time of the transaction. (from TPG paragraph 6.193)

Effectively the exemptions, including that above, relieve a taxpayer of an adjustment under the guidance. In this case, exemption (iii) applies if the appropriate weighting of the actual outcome does not produce an arm's length result that is 20 percent greater or less than the taxpayer's original valuation (*i.e.* a result that is more than 1.2 times, or less than 0.8 times, the controlled transaction price).

Thus, the exemption provisions reflect the concept of a ceiling and a floor that limit a tax administration's ability to adjust a transaction, *ex post*, to more substantial deviations from expected compensation, *ex ante*.

Similarly, arm's length transactions often allow price adjustments while restricting them to price deviations within certain boundaries. For example, parties may negotiate a price floor or a "price cap" in absolute or relative terms. They may also employ a combination of fixed and variable pricing, such as through minimum guaranteed payments in conjunction with variable pricing (*e.g.* a contingent royalty, or a commodity price index). In the author's experience, a variety of *ex post* price adjustment mechanisms are used at arm's length.

In Example 2, most of the same assumptions in Example 1 apply. However, here we see in Year 7 that, *ex post,* sales begin earlier (in Year 5) and reach 1500 in years 5 and 6—substantially exceeding the 1000 yearly maximum foreseen over the entire period in the taxpayer's original valuation that produced an NPV of 700. Again, the taxpayer "cannot demonstrate that its original valuation properly took into account the possibility" of sales reaching such levels, and cannot demonstrate that this possibility was unforeseeable.

In Example 2, an arm's length analysis that properly weights the actual occurrence of sales of 1500 in years 5 and 6 increases the *ex ante* net present value (NPV) of the transferred intangibles—here from 700 to 1300—when one revises the NPV calculations to take the actual sales into account.

In Example 2, exemption (iii) would not apply, as the arm's length result of 1300 would be 1.9 times the taxpayer's original valuation ( 1300 / 700 ). Using the simplified probability weighting shown in equation 1 above—while substituting the arm's length price of 1300 in place of 1000—would indicate the actual outcome ( $NPV_2$ ) in Example 2 to be over 2500, or a multiple of about 3.6 times the taxpayer's original valuation (*i.e.* 2500 / 700 ).

In actual cases involving similar transactions, the discrepancies between taxpayer positions and government positions have been at far greater orders of magnitude. For example, in *Veritas*[3], the government's adjusted position at trial was over 10 times greater than the original taxpayer valuation for transfers involving the rights to develop and commercialize software-related intangibles in international markets.

Hypothetically, if the draft approach had been applied in this case, a question posed might have been: Was it foreseeable that the transferee (Veritas Ireland) would realize anticipated benefits worth 10 times the price it paid for the transferred intangibles in 1999? The answer is, probably, given known facts and stated goals.

In the disputed transaction, the affiliate had obtained virtually all rights in the intangibles in non-US markets for about USD 166 million. At the same time, it was the group's stated strategic goal to expand internationally, as in reflected in its financial disclosures between 1994 and 2004.

Further, according to the decision, at the time of the transfer in 1999, "[Veritas US was] the largest storage software company in the industry" through the success of leading technology it had developed and acquired. It also already had "a distribution channel in Europe, the Middle East, and Africa (EMEA); and a sales force…in Europe."

Data from the group's financial disclosures show that, in the five years subsequent to the intangibles transfer to Veritas Ireland, sales revenue for international operations grew over 40% per year on average, from USD 143 million to over USD 850 million. International sales also represented over 30% of sales on average during the same period, reaching over 40% of total company sales by 2004.

Was the success international markets unforeseen or considered unlikely? If not, what was the probability of success *versus* failure? And what would one sell through these international operations if not the proven, successful technology that already led its market as of the deal in 1999? Why wouldn't an independent party in Veritas US' position choose to retain the non-US rights in the technology and realize the expected value from international sales—*i.e.* why do this deal?

[3] *Veritas Software Corp. v. Comr., 133 T.C. No. 14.*

Example 3 is also a very helpful illustration. It demonstrates that, *ex ante*, a running royalty is not only able to be expressed on a cash equivalent (*i.e.* NPV) basis, but that royalty rates themselves are typically derived from an NPV analysis (*i.e.* NPV of Profit / NPV Sales), for example. It also shows interactions between the royalty rate and the royalty base that may arise when actual *ex post* revenue results are applied to a contingent royalty derived *ex ante*—with potential impact on whether exemptions iii and iv apply.

*Examples, Assumptions and Related References (TPG and BEPS Action Plan)*

The author concurs with and invokes the draft paragraph 14 in the comments above and in elaborating on the examples. In particular, like with the draft examples, nothing in these comments should be taken as prescriptive and the facts and circumstances of each actual case supersede any generalizations related to the examples, these comments or any interpretation of them.

Paragraph 15 describes the draft examples' assumptions, which refer to the final TPG, Chapter VI in key respects. These are addressed here to the extent they relate to these comments. In particular, paragraph 15 describes the transfer in Example 1 as "meeting the criteria for HTVI" in TPG paragraph 6.189. Two criteria are required.

The first of these criteria is the requirement that "no reliable comparables exist" for the controlled transaction. Very often this will be an appropriate criterion to apply the draft approach. However, it occurs to the author that in some cases this may be the subject of dispute—or at least different interpretation.

Taxpayers and governments may disagree as to the reliability of a potential comparable(s), or whether reliable adjustments could be made for material differences between a proposed or purported comparable(s) and the controlled transaction, for example. There may also be different views as to what satisfies the TPG comparability criteria, particularly if adjustments are proposed to improve comparability.

As noted above, it is arguable that the transfer that was subject to the *Veritas* case (U.S. Tax Court, 2009) involved what would today be considered BEPS. The case reflected numerous issues addressed in the draft and related guidance. However, if such a case were analyzed in the context of the draft and the "no reliable comparables exist" criterion, agreement on this requirement would potentially be difficult.

For example, as in that case, a taxpayer might maintain it has identified appropriate comparable transactions. The government's case may dispute that the comparables are reliable, but could it dispute that they exist? The issue may thus become further complicated when there are differing views as to whether reliable adjustments could be made to the comparables—and whether the taxpayer's proposed adjustments are reliable (or not).

The author has commented on the *Veritas* case extensively. In the author's view, whether or not one agrees that the taxpayer's asserted comparables offered useful arm's length evidence, the analysis made adjustments that reduced, rather than increased, the third-party contracts' comparability with the controlled transaction.

Thus, in the draft, the pursuit of common understanding among tax administrations on the subject also seems to call for increasingly common (or, at least, mutually agreeable) interpretations of the TPG more broadly. That said, stated goals and guidance from Action 14 may help overcome such disagreements through the Mutual Agreement Procedure (MAP), as invoked in the draft paragraphs 31 and 32. Consistent views on such issues would also be helpful to fulfil recommendations that bilateral and multilateral APAs be considered.

*Conclusion*

In the author's view, the draft offers useful and insightful recommendations on very complex subject matter—*i.e.* the valuation of intangibles transactions that contribute to BEPS. Among these, the focus on whether actual outcomes were foreseeable or probable *ex ante* is particularly welcome. Additionally, the merits of probability-weighted analysis—a common practice among independent parties in arm's length negotiations—are well-addressed and welcome in this context.

The analytical approaches described in the draft and TPG (Chapter VI, D.3 and D.4) not only consider important aspects of arm's length behavior (*i.e.* what independent parties do). They aptly demonstrate issues affecting what independent would agree to pay (receive) in a transaction, based on their expectations, and anticipated benefits, costs and risks under a range of foreseeable outcomes. Importantly, these approaches consider fundamental tenets of the arm's length principle—that is, they operate in light of the parties' functional, asset and risk profiles and the facts and circumstances of the transaction.

Once again, I greatly appreciate the opportunity to offer comments on the draft and look forward to continuing to assist the OECD's efforts on this and related subjects.

Sincerely,

**Pat Breslin**
*Washington, DC*
June 30, 2017

*(Delivered via email*)

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29 June 2017

Dear Sir/Madam,

## *BEPS Public Discussion Draft on the approach to hard-to-value intangibles: implementation guidance for tax administrations*

PricewaterhouseCoopers International Limited on behalf of its network of member firms (PwC) welcomes the opportunity to comment on the OECD's *Public Discussion Draft on the approach to hard-to-value intangibles: implementation guidance for tax administrations* (Discussion Draft).

We appreciate the efforts from the OECD in developing implementation guidance on hard-to-value intangibles (HTVI) and acknowledge that the issue is complex. However, we believe the concepts outlined in the discussion draft could be improved in several ways in order to provide a common understanding and practice among tax administrations as to how the rules for HTVI should be applied. The factual assumptions underlying the examples lead to the conclusion that the income method is not a reliable transfer pricing method, yet conclude that the income method nonetheless should be used as the basis for making an ex-post transfer pricing adjustment. It would be helpful if this part of the guidance could be reconciled with the existing rules for the best method analysis in the Transfer Pricing Guidelines (TPG). With regards to information asymmetry, we would welcome if the Discussion Draft addressed the difficulties that taxpayers face in valuing the intangible at the time of the transaction. We also suggest that ex post adjustments should only be made by tax administrations when the taxpayer was negligent / has acted in bad faith at the time of the transaction.

The examples in the Discussion Draft do not provide guidance on the basis for determining the amount of ex-post HTVI adjustments. They use evidence based on ex post outcomes to make transfer pricing adjustments, and state that such adjustments should not be based solely on the actual outcome. But guidance is not provided as to how such adjustments should actually be made. We believe it is important to provide objective principles to support the adjustments described in the examples in order to promote a consistent application of the Guidelines. Without objective principles, tax administrations will have no guidance on how to resolve competing claims for income, increasing uncertainty for MNEs.

Finally, it is also noteworthy that while the Discussion Draft notes the importance of granting access to MAP, it does not provide guidance on how to resolve cases of double taxation arising from the application of the approach for HTVI. For example, the conflict arising when one tax authority determines arm's length pricing based on information known at the time of the transaction and another tax authority makes an adjustment for HTVI based on ex post outcomes means that there will be no principled basis to resolve any disputes in MAP. We believe it would be helpful to explicitly recommend that access to MAP should be available in such instances, and we strongly support mandatory binding arbitration.

For any clarification of this response, please contact the undersigned or any of the contacts below. We look forward to discussing any questions you have on the points we raise above or on other specific matters raised by respondents to the Discussion Draft and would welcome the opportunity to contribute to the discussion as part of a public consultation meeting, should such meeting be organised. These comments are discussed in detail in the appendix below.

Yours faithfully,

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# *Appendix*

## 1. Nature of the implementation guidance

It is not clear whether the implementation guidance will be incorporated in the TPG (for example as an annex to the Revised Chapter VI TPG) or published under another format. In our view, when the guidance is only addressed to tax administrations (as exemplified in the titles on p. 1 and 2 of the Discussion Draft), it is not appropriate for them to be included in the TPG, but if these are intended for use both by MNEs and tax administrations, they should be incorporated in the TPG. It is also unclear from when the implementation guidance would be applied (i.e., from the time of publication of the Final Report on BEPS 8-10, from the time of publication of the report on implementation guidance, or from the entry into effect of revised tax treaties or domestic legislation allowing for the use of a presumptive evidence approach). We recommend clarification in the final report.

## 2. Examples

2.1 Selection of the most appropriate method

The first two examples are based on the assumption that, at the time the transaction was entered into, the projections of future cash flows or income expected to be derived from the transferred intangible are "highly uncertain." However, both of those examples use an "income method," based on the discounted value of projected income or cash flows, to make an ex-post transfer pricing adjustment. We wonder how that can be the case, as paragraph 6.163 of the Final Actions 8-10 report provides that the reliability of a valuation of a transferred intangible using discounted cash flow valuation techniques is dependent on the accuracy of the projections of future cash flows or income on which the valuation is based. Based upon the guidance provided in Section D.2.6.4.1 of the Revised Chapter VI TPG on Accuracy of financial projections, one of the key criteria whether an income or cash flow method can be reliably used to determine the transfer price is the accuracy of the projections of future cash flows or income on which the valuation is based. It would be helpful if this part of the guidance could be reconciled with the existing rules for the best method analysis in the TPG.

2.2 Determination of ex post outcomes

We note that the examples do not provide guidance on how the *ex post* adjustment should be determined. Examples 1 and 2 both use evidence based on ex post outcomes to make transfer pricing adjustments, and state that such adjustments should not be based solely on the actual outcome. Yet there is no indication as to what actually is the basis for such adjustments. We believe it would be helpful to include an explanation as to how such adjustments were calculated, in order to promote a common understanding and practice among tax administrations on how to apply adjustments resulting from the application of the approach for HTVI.

2.3 Industry focus

We note that all three examples are set in the pharmaceutical sector. Although the examples are only meant to be illustrative we are concerned that examples that are set in one industry alone may be misinterpreted in a way that this sector is particularly prone to setting prices for transfers of HTVI that may give rise to BEPS issues, and conversely, that there are no HTVI in other industries.

2.4 Safe harbour rules

Scenario B of Example 1 illustrates that when the safe harbour conditions are met as provided for under paragraph 6.193, iii) of the revised Chapter VI TPG, the presumptive evidence approach will not apply. We would welcome guidance to illustrate how the safe harbour of 20 % should apply under additional circumstances, particularly on how the safe harbour rules would apply in a case where the five-year commercialisation period was combined with a 20 % threshold (paragraph 6.198 iv) of the revised Chapter VI TPG).

2.5 Calculation of the adjustments

The outcome of Example 3 concludes that:

- The value at the time of the transfer was not correct, based upon the presumptive evidence approach;
- As a consequence, the royalty rate should have been higher in the years concerned;
- The amount of the primary and corresponding adjustments for open years will be determined in accordance with the domestic law of each of the countries and the rules on statute of limitations applicable to these transactions.

Footnote 1 can be read to indicate, however, that one tax authority can make an adjustment during open tax years with respect to amounts that relate to closed tax years. With regard to this, we believe it is inappropriate for a tax authority to use the HTVI Approach to permit adjustments to royalties paid in years in which the statute of limitations is already closed. But that footnote also implies in the second sentence that if the tax authority of the other state disagrees with that approach, the obligation to relieve double taxation under MAP only relates to the open years. It thus appears to allow (and maybe even encourage) tax administrations to disagree as to the scope of their obligations to relieve double tax in MAP. This would lead to double taxation without any possibility of resolving the issues. We believe that such approach would be contrary to the spirit of the standards and guidance developed under BEPS action 14. We believe it would be helpful to clarify that, to avoid double taxation, a tax administration should make a corresponding adjustment involving an open year, regardless of whether or not the year of the primary adjustment is closed in that jurisdiction

With regard to bullets one and two above, example 3 seems to indicate that in any case where the value at the time of the transfer is higher on the basis of an ex post analysis on the grounds of an income or cash flow based methodology, the royalty rate derived should automatically be higher. This is not necessarily in line with the arm's length principle. At arm's length, parties could have negotiated on the basis of multiple possibilities.

**3. Mutual Agreement Procedure and dispute resolution**

The Discussion Draft recognizes that more transfer pricing related disputes will arise as a result of the presumptive evidence approach, but does not provide guidance on how to tackle those disputes. If one tax authority uses the HTVI approach to make a transfer pricing adjustment which is inconsistent with the arm's length principle because it is based on ex post evidence of actual outcomes which would not have been available to unrelated parties at the time of the transaction, and another tax authority prices that intangible consistent with the arm's length principle, double taxation will result and there will be no principled basis to resolve that dispute through the MAP. We believe it would be helpful to explicitly recommend that access to MAP should be available in such instances, and we strongly support mandatory binding arbitration.

Similarly, the approach for HTVI may be interpreted as an anti-abuse measure in domestic legislation and disallow access to MAP or arbitration. While access to MAP is mentioned in the Discussion Draft, we would recommend clarifying that the presumptive evidence is not intended as an anti-abuse measure and hence access to MAP should be guaranteed.

RELX Group

28 June 2017

To: Tax Treaties, Transfer Pricing and Financial Division, OECD/CTPA

Dear Sir or Madam,

**BEPS Action 8: Discussion Draft on Hard-to-Value Intangibles**

We are writing in response to the OECD's request for comments in relation to the Discussion Draft on Hard-to-Value Intangibles ("HTVIs") released on 23 May 2017.

RELX Group is a global provider of information and analytics for professional and business customers across industries. We operate in four major market segments: Scientific, Technical & Medical; Risk & Business Analytics; Legal; and Exhibitions. RELX Group serves customers in more than 180 countries and has offices in around 40 countries. It employs approximately 30,000 people worldwide.

We set out below our representations on the Discussion Draft. Our representations are focussed on the key issues for RELX Group in relation to the Discussion Draft as follows:

1. The principle proposed in the Discussion Draft is the use of ex post results as presumptive evidence to challenge the pricing of ex-ante transactions, specifically in relation to HTVIs. Businesses need certainty in relation to their transactions and we consider that the use of *ex post* information would create a high level of uncertainty for multinational groups. In fact, this will increase the ability of the tax administrations to challenge pricing, in some cases many years after the transaction has taken place. We do not consider the use of ex post information to be a reasonable or proportionate approach to re-price transactions.

2. Sections 7 to 11 of the Discussion Draft refer to timing issues and indicate that audit procedures should apply to recognise HTVI and act upon these as early as possible. We appreciate the difficulties that tax administrations may encounter in performing an analysis at the time the transaction took place or shortly after. We also acknowledge that HTVI may take several years before being exploited and generating income. However, to permit tax authorities to undertake analysis several years after the event creates a significant degree of uncertainty. In fact, they fail to specify what should be the appropriate weighting of foreseeable developments or events relevant for the valuation at the time of the transaction.

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3. We would, therefore, fully support the use of cooperative compliance programmes between taxpayer and tax administration, which would assist in identifying HTVI in an early stage. We would prefer to see countries incorporating a statute of limitations that will allow tax administrations to collect the relevant information within a reasonable length of time and will bring tax payers the certainty they require.

4. Section 12 of the Discussion Draft refers to Paragraph 6.192 - Section D.4 of the Revised Chapter VI of the OECD Transfer Pricing Documentation (Final Reports for Action 8 – 10) which states that adjustments based on *ex post* profit levels should not be made where "the tax administration is able to confirm the reliability of the information on which *ex ante* pricing has been based". It is not clear as to the evidence tax administrations may require to "confirm the reliability" of the information used. It places the onus on the taxpayer to demonstrate this by asking, for example, for the taxpayer to provide satisfactory evidence that any significant difference between the financial projections and actual outcomes is due to unforeseeable or extraordinary developments or events occurring after the determination of the price. This seems to be an impossibly high hurdle; almost by definition it is extremely difficult to prove that – after the event – something could not have been foreseen.

5. Instead, we consider that the onus should be on the tax administration to demonstrate that it was not considered reasonable at the time of the transaction for the taxpayer to rely on the information used to value the transaction. Therefore, the tax administration should only have the option of using *ex post* pricing to adjust a transaction where it can demonstrate that the information used by the taxpayer for the *ex-ante* pricing was clearly unreliable at the time the original transaction took place.

6. Similarly, Section 6 states that "it would be incorrect to base the revised valuation on the actual income or cash flows without also taking into account the probability, at the time of the transaction of the income or cash flows being achieved". While that seems to be a reasonable principle, there is no explanation or guidance as to how this might be achieved in practice. Any assessment of what the probability of an outcome might have been, made after the event, would necessarily be highly judgemental and clouded by hindsight.

7. Section 13 of the Discussion Draft states that "tax administration can consider *ex post* outcomes as presumptive evidence about the appropriateness of the *ex-ante* pricing arrangements". The generally accepted rule in business and in law is that once the parties enter into an *ex-ante* agreement, they will have to perform their rights and obligation under the contract regardless of what the *ex-post* result is. Neither related nor unrelated parties have the benefit of hindsight when entering into business transactions. Whilst we acknowledge that there is informational asymmetry between the tax authority and the taxpayer, businesses will use the best information available to them at the time when entering into commercial arrangements. As long as that information was considered to provide a reasonable basis for valuing the transaction at the time the transaction took place, we consider there should be no reason to adjust the transaction price based on ex post information. The Discussion Draft does not currently permit multinationals to consider *ex post* outcomes. It is possible that the *ex post* data indicates that the taxpayer has brought too much into tax or has had too small a deduction. If it were only the tax administrations permitted to make adjustments, then that would also result in a fundamental and inequitable asymmetry.

8. The examples provided in the Discussion Draft are limited to the pharmaceutical industry and they do not provide clarity for businesses operating in other industries. We would encourage the inclusion of more examples covering different industries.

9. We agree with the statement at section 31 of the Discussion Draft that it is important to permit resolution of cases of double taxation through MAP. That will only be viable in practice, however, when both taxing authorities accept the principle of *ex post* adjustments. As the consultation recognises implicitly at paragraph 11, not all tax authorities will wish to permit *ex post* adjustments. This gives rise to the very real possibility of asymmetry and double taxation where taxing authorities take opposing views on the subject.

10. We consider that APAs could also play a role in providing greater certainty for taxpayers regarding HTVIs. By using an APA in such cases, the taxpayer and tax administration could agree how to deal with HTVIs up front and even agree on what evidence is required to avoid a later review and adjustment based on subsequent information. However, we also recognise that APAs can take a substantial amount of time to agree and an increase in the volume of applications could put a heavier burden on APA teams within tax administrations, which could further extend the time taken to reach an agreement.

We would like to thank you for providing us with the opportunity to comment on the Discussion Draft and look forward to being included in the discussion process.

Yours faithfully

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Mr. Jefferson VanderWolk
Tax Treaties, Transfer Pricing and Financial Transactions Division
OECD Centre for Tax Policy and Administration

Submitted by email: TransferPricing@oecd.org

June 30, 2017

**SUBJECT: DISCUSSION DRAFT ON THE APPROACH TO HARD-TO-VALUE INTANGIBLES: IMPLEMENTATION GUIDANCE FOR TAX ADMINISTRATIONS**

Dear Mr. VanderWolk,

RSM UK and RSM Netherlands ("RSM" or "we") appreciate the opportunity to provide comments on: "Discussion Draft on BEPS Action 8 Implementation Guidance on Hard-to-Value Intangibles as released by the OECD on May 23, 2017 ("the Discussion Draft"). This letter encompasses the view of RSM UK and RSM Netherlands.

Yours sincerely,

Ken Almand / Juan Dosal

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**COMMENTS ON THE DISCUSSION DRAFT ON THE APPROACH TO HARD-TO-VALUE INTANGIBLES: IMPLEMENTATION GUIDANCE FOR TAX ADMINISTRATIONS**

In this letter we provide comments on the discussion draft on the approach to hard-to-value intangibles ('HTVI") released by the OECD on May 23, 2017. This letter includes our understanding of the purpose of the guidance proposed by the OECD; followed by our understanding of what constitutes HTVIs and then our comments to the draft guidance on the approach to HTVIs as released by the OECD.

## A. Purpose of the guidance:

We understand that the purpose of the guidance is to protect tax administrations from the negative effects of information asymmetry by ensuring that they can consider *ex-post* outcomes as presumptive evidence about the appropriateness of *ex-ante* pricing arrangements. Moreover, the guidance is also intended to provide the taxpayer with the possibility to rebut such presumptive evidence by demonstrating the reliability of the information supporting the pricing methodology adopted at the time the controlled transaction took place.

## B. Scope of the guidance:

HTVIs are defined as "intangibles or rights in intangibles for which, at the time of their transfer between associated enterprises, (i) no reliable comparables exist; and (ii) at the time the transaction[s] was entered into, the 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, making it difficult to predict the level of ultimate success of the intangible at the time of the transfer."

The asymmetry of information between taxpayers and tax administrations about the potential value of HTVIs, as well as the time that may have elapsed since the time the transaction was entered into, make it particularly difficult for tax administrations to test the pricing of the transaction. The transfer pricing approach to value HTVI's as provided in the final report of Actions 8-10 of the Action Plan on Base Erosion and Profit Shifting (BEPS) released in 2015 by the OECD, is intended to protect tax administrations from the negative effects of information asymmetry, while also allowing taxpayers to demonstrate that the pricing of HTVIs is at arm's length through a thorough transfer pricing analysis.

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The guidance included in the final report authorizes tax administrations to use *ex-post* evidence on the financial outcomes of an intangible transaction (i.e., information gathered in hindsight about how valuable an intangible has turned out to be) as presumptive evidence on the appropriateness of the *ex-ante* pricing arrangements. Tax administrations may use such *ex-post* evidence to determine the pricing arrangements that would have been made at the time of the transaction between independent enterprises, including any contingent arrangements (such as milestones payments or stepped royalties) that might have been agreed.

However, such presumptive evidence may not be used where certain circumstances or safe harbors apply, including:

- Where the taxpayer can demonstrate that *ex-ante* projections used at the time of the transfer to determine the pricing arrangements were reliable, taking into account risks and reasonably foreseeable events that might have affected the outcomes. The taxpayer also needs to provide reliable evidence that any significant difference between the projections and actual outcomes is due either to unforeseeable developments, or to the playing out of foreseeable outcomes whose probabilities were originally reasonably estimated;
- The difference between financial projections and actual outcomes does not reduce or increase compensation arising from the HTVI by more than 20% of the compensation determined at the time the transaction was entered into;
- A commercialization period of five years has passed and the difference between financial projections and actual outcome in this period has not been more than 20%;
- The transfer of an HTVI is covered by a bi- or multilateral advance pricing agreement.

## C. Our comments:

The guidance seeks to tackle perceived tax planning and avoidance that uses HTVI and encompasses elements of the final report on BEPS Actions 8-10. Whilst such planning has undoubtedly been used over the years we have a concern that the HTVI may be used in situations that fall outside of this context.

By their very nature HTVI are not only difficult to value, but in many instances may even be hard to identify. We would see value in putting additional into the guidance to emphasise that:

- HTVIs may be difficult for both a taxpayer and a tax administration to identify;
- By their nature they are difficult to value;

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- The *ex-post* approach should be used with caution and may not be appropriate to all situations where HTVIs may be in point.

There is a general presumption in the Draft that the taxpayer has all the relevant information about the HTVI and is able to identify and attribute value to future events and circumstances. We agree that in certain circumstances tax administrations may suffer from "*the negative effects of information asymmetry*" (the Draft, pt 2) however in our experience many taxpayers will not possess economic or commercial foresight to a degree which the general tone of the draft suggests.

The power that is placed in the possession of tax administrations to use hindsight by way of the *ex-post* approach is significant and the draft should recognise this and the fact that taxpayers typically experience considerable opaqueness when seeking to set an *ex-ante* valuation for HTVIs.

The information asymmetry may often not be as wide as the draft suggests and could cause an over exuberant tax administration to use an *ex-post* approach that overestimates the extent to which the taxpayer was able to foresee future impacts upon HTVI values.

The *ex-post* approach undermines the long held principle that hindsight should not be used to determine arm's length pricing, when it can be evidenced that third parties would have established the pricing on *ex-ante* basis.

There is concern that because the use of hindsight will effectively only be available for the benefit of tax administrations that it could be used in situations where genuine HTVIs are not in point or to deem that a taxpayer pursued transactions with a tax planning motive. *"Where […] the actual income or cash flows are significantly higher than the anticipated income or cash flow on which the pricing was based, then there is presumptive evidence that the projected income used in the original valuation should have been higher"* (the Draft, pt 6).

Example 1 of the Draft (pt 17 et seq) demonstrates the reversal of the perceived information asymmetry. The example uses a case where a partially developed pharmaceutical drug is sold within a group and the taxpayer has to demonstrate that its original valuation properly took into account the possibility that sales would arise in earlier periods and has to "*demonstrate that such a development was unforeseeable*" (the Draft, pt 19). In practice this means that taxpayers will be likely to need to incur an increased compliance burden when considering the price for an HTVI. In the example the taxpayer would have needed to

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undertake and document evidence that the development was unforeseeable. This appears to be an unrealistic burden and one which is likely to prove extremely challenging in practice. It is welcome that there is an example that refers to the *de-minimis* rule prohibiting transfer pricing adjustments that are smaller than 20% of the originally determined transfer price. However, it would be preferable if the guidance were to emphasize other situations under which tax administrations should refrain from using *ex-post* evidence and then further clarify the point with examples covering those situations.

Finally, given that the use of hindsight is effectively only available to tax administrations, we would propose that the draft recognises the difficulty for taxpayers in identifying and valuing HTIVs and that the approach should be used in defined circumstances only. Furthermore the practical challenges for taxpayers should be recognised and reflected in the guidance and the implied presumption that HTIVs are typically a vehicle for tax planning should be tempered.

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June 30, 2017

**VIA ELECTRONIC TRANSMISSION**

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**Re: Comments on May 23, 2017 OECD Public Discussion Draft on BEPS Action 8 *Implementation Guidance on Hard-to-Value Intangibles***

Dear Sirs or Madams,

The Silicon Valley Tax Directors Group ("***SVTDG***") hereby submits these comments on the above-referenced Public Discussion Draft ("***PDD***"). SVTDG members are listed in the Appendix of this letter.

Sincerely,

Robert F. Johnson

Robert F. Johnson
Co-Chair, Silicon Valley Tax Directors Group

# I. Introduction and summary

## A. Background on the Silicon Valley Tax Directors Group

The SVTDG represents U.S. high technology companies with a significant presence in Silicon Valley, that are dependent on R&D and worldwide sales to remain competitive. The SVTDG promotes sound, long-term tax policies that allow the U.S. high tech technology industry to continue to be innovative and successful in the global marketplace.

## B. Summary of comments

The SVTDG thanks the OECD for providing guidance on implementation of the HTVI approach outlined in § D.4 of the 2016 *Transfer Pricing Guidelines* (¶¶ 6.186–6.195), and for giving taxpayers an opportunity to comment on the PDD. The SVTDG believes some guidance in the PDD is helpful, but the PDD is deficient in certain respects (explained below). The HTVI approach is, for most tax administrations, a new tool to potentially apply to associated enterprise transactions involving HTVI. The SVTDG accordingly asks the OECD to address the deficiencies to give greater certainty to taxpayers and tax administrations.

At the outset, we reiterate a point we made in a previous comment letter that Article 9, ¶ 1 of the OECD *Model Tax Convention* provides no authority for recharacterizing an associated enterprise transaction. Accordingly, we recommend the PDD be revised to clarify that tax administrations can't impose alternative payment structures when applying the HTVI approach.

We also recommend four other sets of changes be made to the PDD. First, it should be revised to include practical examples of how a taxpayer could demonstrate exemption i), requirement 2 applies. This exemption from an adjustment under the HTVI approach applies if—in the case of a significant difference between projections and actual outcomes—a taxpayer can proffer evidence about either the unforeseeability of the cause of the significant difference, or the playing out of probabilities of foreseeable outcomes. More guidance is needed for implementation. Second, we also recommend the OECD adopt rules of administrative convenience, pursuant to which no HTVI adjustment will be made if the tax administration of one of the jurisdictions relevant to an associated enterprise transaction asserts either non-application of the HTVI approach or proper application of one of the four exemptions. Third, the PDD should be revised to explain how a lump-sum arm's length price can be redetermined using a small number of years of actual data. Fourth, the PDD should be revised to clarify that tax administrations should, when considering HTVI adjustments, take appropriate taxpayer-favorable *ex post* outcomes into account as offsets.

## II. Specific concerns with the PDD

### A. Article 9, ¶ 1 of the OECD *Model Tax Convention* provides no authority for making certain adjustments under the HTVI approach

The PDD states that "[i]n implementing the HTVI approach . . . tax administrations may make appropriate adjustments, including adjustments that reflect an <u>alternative pricing structure</u> that is different from the structure adopted by the taxpayer (for example, milestone payments, running royalties with or without adjustable elements, price adjustment clauses, or a combination of these characteristics)."[1]

Recharacterization of the terms of a transaction among associated enterprises would be contrary to the arm's length principle. Accordingly, any such recharacterization by a tax administration would be subject to challenge by a taxpayer as being contrary to Article 9, ¶ 1 of the OECD *Model Tax Convention*. We raised this point in the letter submitted June 18, 2015 by the SVTDG commenting on the June 4, 2015 *Public Discussion Draft—BEPS ACTION 8: HARD-TO-VALUE INTANGIBLES*. In that letter we explained that application of Article 9, ¶ 1 requires delineation of the "commercial or financial relations" between associated enterprises, and for this purpose local-country tax law typically includes some version of a substance-over-form (or related) principle allowing recharacterization of an associated-enterprise transaction according to its substance. We further explained that such recharacterization is required to properly apply Article 9, ¶ 1 if the substance of such a transaction doesn't mirror its form, but Article 9, ¶ 1 itself doesn't authorize recharacterization in any other circumstances. The SVTDG believes, additionally, that *ex post* adjustments outside the terms of a written agreement between parties at arm's length are rarely, if ever, made.

The SVTDG accordingly recommends that the PDD be reissued to clarify the sorts of HTVI adjustments permissible under Article 9, ¶ 1—in particular, the PDD should clarify that recharacterization of the payment structure is impermissible.[2] The "alternative payment structures" discussed in *Example 2* are instances of such impermissible recharacterization.

### B. The PDD should be revised to include one or more examples showing how a taxpayer could demonstrate exemption i), requirement 2, applies

*Example 1,* Scenario A assumes "[t]he taxpayer cannot demonstrate that its original valuation properly took into account the possibility that sales would arise in earlier periods, and

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1 PDD, ¶ 12 (emphasis added). The PDD references *TPG* ¶ 6.192 for this assertion.

2 PDD, ¶ 12 references in general a tax administration's ability to impose alternative pricing structures under an HTVI approach. This should be retracted.

cannot demonstrate that such a development was unforeseeable."[3] *Example* 2 has a corresponding assumption.[4] These assumptions are presumably meant to signal inapplicability of exemption i) from an HTVI adjustment. Exemption i) provides that an HTVI adjustment won't be made if:

> i) The taxpayer provides:
>
> 1. Details of the *ex ante* projections used at the time of the transfer to determine the pricing arrangements, including how risks were accounted for in calculations to determine the price (e.g. probability-weighted), and the appropriateness of its consideration of reasonably foreseeable events and other risks, and the probability of occurrence; <u>and</u>,
>
> 2. Reliable evidence that any significant difference between the financial projections and actual outcomes is due to:
>
> a) unforeseeable developments or events occurring after the determination of the price that could not have been anticipated by the associated enterprises at the time of the transaction; or
>
> b) the playing out of probability of occurrence of foreseeable outcomes, and that these probabilities were not significantly overestimated or underestimated at the time of the transaction.[5]

The assumptions in *Example 1* and *Example 2* mean, in particular, neither alternative element a) nor b) of requirement 2 from exception i) applies.[6]

An HTVI adjustment to an arrangement among associated enterprises could have serious consequences. It's important for tax authorities and taxpayers to understand how the four exemptions from such an adjustment would apply. Exemptions ii)–iv), which appeared first in the *BEPS Actions 8–10 Final Report*, are relatively "mechanical" to apply compared with exemption i). *Example 1*, Scenario B, and *Example 3* show application of exemption iii).

Exemption i) isn't mechanical to apply. A taxpayer may be able to meet requirement 1 of exemption i) with transfer pricing documentation prepared in connection with an HTVI

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3 PDD, ¶ 19.

4 PDD, ¶ 24 ("The taxpayer cannot demonstrate that its original valuation properly took into account the possibility that sales would reach these levels, and cannot demonstrate that reaching that level of sales was due to an unforeseeable development.").

5 *2016 TPG* and *BEPS Actions 8–10 Final Reports*, ¶ 6.193 (emphasis added)

6 If a taxpayer can't demonstrate its original valuation properly took into account the possibility that sales would arise in earlier periods—meaning presumably the taxpayer can't demonstrate the validity of its (perhaps tacit) assignment of zero probability of sales in earlier periods—then element 2b) isn't met. If a taxpayer can't demonstrate that such a development (i.e., sales in an earlier period than expected) was unforeseeable, element 2a) isn't met.

transaction.[7] Requirement 2 of exemption i) is novel in the *TPG*. The OECD should provide guidance on how both alternative prongs a) and b) could be met. Taxpayers should in theory be better off with a choice of meeting either of the two prongs,[8] but this choice is only meaningful if it's clear how each of the prongs could be met. Without guidance on application of these prongs of exemption i), taxpayers risk tax administrations denying application of the exemption with little or no rational explanation.

To meet prong 2a), a taxpayer has to proffer reliable evidence that any described significant different is due to unforeseeable developments or events. That is, a taxpayer needs reliable evidence (I) showing the developments or events that are the cause of the significant difference; and (II) showing that such developments or events were unforeseeable. Finding reliable evidence showing developments or events causing the significant difference (i.e., (I)) may be challenging, but the task is readily understood. But how would a taxpayer produce reliable evidence such developments or events were unforeseeable (i.e., (II))? Is absence of evidence equivalent, in this context, to evidence of absence? Again, taxpayers trying to muster such evidence face the risk a tax administration could, without rational explanation, simply deny suitability of evidence. The OECD should provide one or more examples showing how taxpayers could meet this prong 2a). To be of help, these examples shouldn't use idealized fact patterns uncommon in real-world situations.

To meet prong 2b), a taxpayer has to proffer two kinds of reliable evidence: (I) reliable evidence showing that any described significant difference is due to the playing out of probabilities of foreseeable outcomes; and (II) reliable evidence showing these probabilities were reasonably well estimated *ex ante*.[9] How could this be done? To make things extremely simple, suppose, for example, a taxpayer estimated sales of 10, 20, & 30, each with probability ⅓rd, so the expected sales (upon which a transfer price is determined) are 20, and that actual sales are 30, assumed to be "significantly different" than taxpayer's projection of 20. How, from a single actual outcome—in probabilistic terms, a single outcome of an experiment—could the taxpayer demonstrate its probability estimates were reasonable,[10] and that the significant difference was due to the playing out of those probabilities? How could the taxpayer rebut a tax administration's assertion that the probability associated with the outcome 30 was unreasonably

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7 Such documentation may include estimates of prices, events or occurrences, and associated probabilities.

8 Prong b) appeared first in the *BEPS Actions 8–10 Final Report*.

9 These two conditions appear to be related if all outcomes are foreseeable, inasmuch as if, in this context, a taxpayer reasonably-well estimates probabilities associated with all foreseeable outcomes, any significant difference as described must be due to the playing out of probabilities.

10 "reasonably well" meaning not significantly overestimated and not significantly underestimated.

low? Real world examples will almost certainly be more complicated, involving outcome ranges and associated probabilities. The OECD should provide one or more examples showing how taxpayers could meet this prong 2b). To be of help, these examples shouldn't use idealized fact patterns uncommon in real-world situations.

We understand meeting prong 2a) or 2b) of exception i) in practice will invariably depend on a taxpayer's detailed facts and circumstances. We also understand the OECD justifies HTVI adjustments in part because of asserted information asymmetry between taxpayers and tax authorities.[11] The OECD may, accordingly, assert taxpayers are in the best position to appreciate what evidence should be mustered, and thereby refrain from providing practical guidance in this area. But it is incumbent on the OECD to help taxpayers and tax administrations understand how this important exemption i) to the (new) HTVI approach can apply in practice. Without such guidance, the above-outlined risks, with the potential for arbitrary application of the HTVI approach by tax administrations, remain.

### C. The PDD should be revised to include two rules of administrative convenience to simplify application of the HTVI approach and reduce risks of double taxation

The determination of what constitutes acceptable "evidence," what makes that evidence "reliable," and whether such evidence demonstrates the requisite point in prongs 2a) or 2b) is inherently subjective. In recognition of this point, the SVTDG recommends the OECD provide a rule of administrative simplicity: if the tax administration of one of the jurisdictions to an HTVI transaction among associated enterprises believes a taxpayer has met its burden under either prong 2a) or 2b), so that exemption i) applies, the other tax administration will respect that belief and not make an adjustment under the HTVI approach. This rule will simplify application of the HTVI approach.

More broadly, the ability of a tax administration to make an HTVI adjustment increases the likelihood of double taxation. The SVTDG accordingly recommends the OECD adopt a rule pursuant to which if the tax administration of one of the jurisdictions to an asserted HTVI transaction among associated enterprises believes either (1) one of the four exemptions to an HTVI adjustment applies, or (2) an HTVI adjustment otherwise shouldn't be made, then the other tax administration will respect that belief and not make an adjustment under the HTVI approach. This rule will also simplify application of the HTVI approach and reduce instances of double taxation.

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[11] *2016 TPG* and *BEPS Actions 8–10 Final Reports*, ¶ 6.191; PDD ¶ 5.

**D. The PDD should be revised to explain how a lump-sum arm's length price can be redetermined based on a small number of years of actual data**

*Example 2* (sales earlier, and greater, than anticipated) assumes a present value lump-sum arm's length amount can be redetermined based on a couple of years of actual data:

> The taxpayer's original valuation is revised to include the possibility of higher sales resulting in a revised net present value of the drug in Year 0 of 1300 instead of 700. Therefore, assume for the purposes of the example that the arm's length price anticipated in Year 0 should have been 1300. Note that the value of 1300 is not necessarily the net present value of the transferred rights based solely on the actual outcome (see paragraph 6 of this implementation guidance).[12]

*Example 1* (sales earlier than anticipated) has a similar statement and caveat.[13] Referenced paragraph 6 provides:

> Where, for example, the actual income or cash flows are significantly higher than the anticipated income or cash flows on which the pricing was based, then there is presumptive evidence that the projected income or cash flows used in the original valuation should have been higher, and that the probability-weighting of such an outcome requires scrutiny, taking into account what was known and could have been anticipated at the time of entering into the transaction involving the HTVI. However, it would be incorrect to base the revised valuation on the actual income or cash flows without also taking into account the probability, at the time of the transaction of the income or cash flows being achieved. [Emphasis added]

In *Example* 2, the caveat and reference to paragraph 6 mean presumably the taxpayer's original valuation is revised to take into account outcomes including non-zero sales in year 6, and sales greater than 1000 in year 7, with associated probabilities.

But the point remains that the taxpayer's original valuation is revised, yielding what's presumed to be an arm's length result, based on a small number of years of actual data. Implicit is the assumption that *ex post* outcomes in later years don't influence the revised valuation—i.e., the assumption that neither outcomes nor associated probabilities in later years are changed in redoing the valuation. In particular, in the *Examples* the taxpayer isn't permitted to show its original valuation should have accommodated revised outcomes and/or associated probabilities in later years. The PDD should be clarified to make this assumption clear. In section D we explain that a taxpayer should in certain circumstances be permitted to revise its original valuation to get an offset to an HTVI adjustment.

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[12] PDD, ¶ 25 (emphasis added).

[13] PDD, ¶ 20.

**E. The PDD should clarify that tax administrations should, when considering HTVI adjustments, take appropriate taxpayer-favorable *ex post* outcomes into account**

*Example 1* and *Example 2* each involve a situation in which actual sales in two consecutive taxable years are greater than anticipated—in *Example 1* actual sales occur two years before sales are anticipated, and in *Example 2* actual sales occur a year before they're anticipated and are greater than anticipated. Both *Examples* conclude the tax administration can make a positive adjustment to the taxpayer's income. Exemption i) doesn't apply because (somehow) the taxpayer can't show that either [a] these developments were unforeseeable, or [b] the original valuations properly took into account the actual occurrence—i.e., the original valuation took into account the possibility of the actual outcome occurring and assigned a reasonable probability to this occurrence.

It could happen, however, that sales are <u>less than</u> anticipated, and a taxpayer can't show its original valuation properly took this into account. In this case the taxpayer should be able to use any such less-than-anticipated sales as a setoff against an HTVI adjustment increasing its taxable income. The *BEPS Actions 8–10 Final Reports* assert the HTVI approach is justified on the basis of the arm's length principle—i.e., they assert parties at arm's length would, in certain circumstances, modify the pricing or terms of their agreement on the basis of *ex post* outcomes.[14] Rational application of this argument would mean adjustments flowing both ways should be taken into account. Accordingly, the HTVI approach shouldn't function as a one-way ratchet, permitting only additions to a taxpayer's income without taking into account relevant taxpayer-favorable *ex post* outcomes. The PDD accordingly should be revised to clarify that a taxpayer can use favorable adjustments, as outlined above, as a setoff against HTVI adjustments increasing its income.

Timing is also relevant. *Example 1*, Scenario A, and *Example 2* conclude HTVI adjustments increasing a taxpayer's income are warranted based on the first two years of non-zero sales. Possible significant differences between actual and anticipated outcomes in later years are assumed away: we're told revision of the taxpayer's original valuation to accommodate the first two years of nonzero sales yields an amount assumed to be arm's length. Less simplistic cases could well involve some years in which actual sales significantly exceed anticipated sales, and other years in which they fall well short, and in both cases a taxpayer can't show its original

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[14] "In evaluating the *ex ante* pricing arrangements, the tax administration is entitled to use the *ex post* evidence about financial outcomes to inform the determination of the arm's length pricing arrangements, including any contingent pricing arrangements, that would have been made between independent enterprises at the time of the transaction . . . ." *BEPS Actions 8–10 Final Reports*, ¶ 6.192. As explained above in section A, the SVTDG believes the arm's length principle in Article 9, ¶ 1 of the OECD *Model Tax Convention* doesn't authorize recharacterization of the transaction, such as through deeming an alternative pricing structure.

valuation properly took these outcomes into account. If such shortfall years precede excess years, the HTVI approach should permit the shortfalls to offset any HTVI adjustment triggered in excess years. If such shortfall years follow excess years, taxpayers should be permitted either (a) if practicable, to use shortfalls to offset any to-be-made HTVI adjustment triggered in the excess years;[15] or (b) otherwise, to use shortfalls as a basis for a refund claim if an HTVI adjustment has been made based on excesses in earlier years.

The SVTDG accordingly recommends the PDD be revised to clarify that tax administrations should, when considering HTVI adjustments, take appropriate taxpayer-favorable *ex post* outcomes into account as outlined above.

[15] In *Example 2*, for instance, the taxpayer may be able to demonstrate shortfalls in years 7 and beyond, offsetting HTVI adjustments triggered by excesses in years 5 & 6.

Accenture
Activision Blizzard
Acxiom
Adobe
Agilent
Amazon
Apple
Applied Materials
Atlassian
Autodesk
Bio-Rad Laboratories
BMC Software
Broadcom Limited
Brocade
Cadence
Chegg, Inc.
Cisco Systems Inc.
Coherus BioSciences, Inc.
Dell Inc.
Delphi
Dolby Laboratories, Inc.
Dropbox Inc.
Electronic Arts
Expedia, Inc.
Facebook
Fitbit, Inc.
Flex
Fortinet
GE Digital
Genentech
Genesys
Genomic Health
Gigamon
Gilead Sciences, Inc.
GitHub
GLOBALFOUNDRIES
GlobalLogic
Google Inc.
GoPro
Harmonic
Hewlett-Packard Enterprise
HP Inc.
Indeed.com
Informatica
Ingram Micro, Inc.
Integrated Device Technology
Intel
Intuit Inc.
Intuitive Surgical
KLA-Tencor Corporation
Lam Research
Marvell
Maxim Integrated
Mentor Graphics
Microsemi
Microsoft
NetApp, Inc.
Netflix
NVIDIA
Oracle Corporation
Palo Alto Networks
PayPal
Pivotal Software, Inc.
Plantronics
Pure Storage
Qualcomm
salesforce.com
Sanmina-SCI Corporation
Seagate Technology
ServiceNow
ShoreTel
Snapchat, Inc.
SurveyMonkey
Symantec Corporation
Synopsys, Inc.
Tesla Motors, Inc.
The Cooper Companies
The Walt Disney Company
Theravance Biopharma
TiVo Corporation
Trimble, Inc.
Twitter
Uber Technologies
Veeva Systems
Veritas
Visa
VMware
Western Digital
Xilinx, Inc.
Yahoo!
Yelp

**30 June 2017**

**Via E-Mail**
TransferPricing@oecd.org

**The OECD**
**To: Tax Treaties, Transfer Pricing and Financial Transactions Division, OECD/CTPA**

**DISCUSSION DRAFT: BEPS Action 8 – Draft Implementation Guidance on Hard-to-Value Intangibles (HTVI) for Public Discussion Purposes (the "Draft")**

Dear Madam/Sir

The business federation SwissHoldings represents the interests of 61 Swiss-based multinational enterprises from the manufacturing and service sectors (excluding the financial sector).

SwissHoldings is pleased to provide comments on the Draft which the OECD released on May 23, 2017.

Our comments to the Draft are hereinafter provided.

## General Comments

1. According to Section 3 of the Draft, one of the objectives of this new guidance is to *"improve consistency and reduce risk of economic double taxation".* We are pleased that this objective is explicitly mentioned. However, we doubt that this objective will be met. The Draft, in its current version, cannot reasonably be transposed into local regulations without raising more tax uncertainty, subjective interpretations and therefore more controversies, which this Draft is supposed to mitigate. Therefore we expect that the Draft's implementation will lead to significantly more requests for mutual agreements procedures, raising additional administrative burden and costs for both Tax Authorities and taxpayers.

2. The Draft does not provide any useful or additional clarification to the HTVI Guidelines previously published. Moreover, the language of the Draft is one-sided. Please consider that the OECD Transfer Pricing Guidelines are the guidelines for Tax Administrations and MNEs. The Draft should be rephrased in a way that makes clear that the concept of HTVI approach is not a tool for Tax Authorities to justify systematic tax reassessments of HTVI valuations based on ex-post information.

3. As already outlined in our letter of June 15th 2015, we would like to highlight again that the valuation of intangible transfers within an MNE and the respective determination and documentation of the arm's length price is a challenging task for taxpayers. In addition, the valuation of intangibles generally includes a certain element of uncertainty with regard to valuation parameters. Nevertheless, in practice, standard valuation models have been

developed and applied many times which are generally accepted by taxpayers and Tax Authorities for the majority of the intangible transfers. The Draft should build on those and provide further guidance.

4. The OECD should further clarify and state in the Transfer Pricing Guidelines that adjustment mechanisms are applicable only in exceptional or limited cases, with a clearer and narrower definition of HTVI. The possibility of Tax Authorities to arbitrarily apply the HTVI regulations ex-post must be limited as much as possible. It should not be used as an avenue by Tax Authorities to unduly penalise taxpayers who do not have the benefit of hindsight at the point of valuing the intangible /HTVI. Tangible examples of what an HTVI is or is not would be appreciated.

5. The contractual terms (including /or excluding price adjustment clauses as an option that taxpayers should consider and document ex-ante) need to be respected by the Tax Authorities. The burden of proof for another treatment needs to remain with the Tax Authorities and not be transferred to the taxpayers, as apparently contemplated by the current Draft. A clarification on this point would be highly appreciated.

6. We understand the assumption that taxpayers have more information than Tax Authorities. However, we strongly believe that the “lack of information” on the Tax Authorities’ side should be sufficiently balanced with appropriate documentation of the HTVI valuation that taxpayers have anyway to prepare based on Chapter V of the Transfer Pricing Guidelines. Balancing this “lack of information” with the ex-post presumptive evidence proposed by the Draft is in our view excessive. The Draft should define what “good Transfer Pricing documentation looks like” for an HTVI transfer, and should acknowledge that taxpayers also do not have full information because of the core nature of an HTVI. As soon as taxpayers have provided appropriate transfer pricing documentation, the burden of proof should rest with the Tax Authorities.

7. As indicated above, price adjustment clauses are the exception and limited with regards to the applicable time horizon. Hence, we would appreciate that the OECD states a time horizon of 1 year, or otherwise up to 3 years maximum, for which price adjustment clauses could be considered and applied, unless it can be proven that third parties would have agreed on a longer time horizon. Based on our experience, third parties do not normally agree on price adjustment clauses with a time horizon longer than 3 years (exceptions are observed with regard to compensation for specific “liabilities/risks” in M&A deals). Any longer time horizons may result in double taxation and would significantly increase the compliance burden for taxpayers.

8. The Draft content, in any case, will not work without prompt and wide alignment on the tax procedural framework: (a) Statute of Limitations, (b) legal grounds specifically addressing the audit of HTVI valuations, (c) easy access to Advance Pricing Agreements, (d) access to effective and binding Mutual Agreement Procedures, (e) clear transfer pricing documentation rules, and (f) exclusion of late interest and/or penalties in case valuation adjustments required according to the taxpayers’ arrangements.

### Transfer Pricing Documentation – “What good looks like”?

9. As mentioned above, the “lack of information” on the Tax Authorities’ side should be addressed with transfer pricing documentation requirements to be as clear and simple as possible. Unfortunately, the Draft is not addressing this important topic at all. Further substantial work is required in this area. Key open questions to be addressed for example:
    a. How many cash-flow scenarios and probabilities are sufficient?

b. Are worst vs. best vs. 50/50 (mid-point between worst and best) scenarios sufficient?
c. What is "*reliable information*", and which types of data are acceptable?
d. Are management data sufficient or do they have to be verified by an independent third party?

10. In our opinion and if available, the taxpayers' internal processes and methodologies already existing for third party IP transfers should be the starting point for Tax Authorities' analyses: these internal processes and methodologies for third party deals should have been recognized by the OECD as presumptive evidence of tax compliance, provided that the taxpayers can document that the valuation of an intragroup transfer of HTVI /IP has followed the same processes and methodologies as those applied internally for the valuation of third-party transfers of HTVI /IP.

11. We appreciate that according to Section 10 of the Draft, the new guidance should not be used to "*delay or bypass normal audit procedures*". However to meet this objective, clear guidance and timelines need to be defined. For example, what should "*as early as possible*" (Draft, Sections 7 and 10) be? What is the time window for the Tax Authorities to collect ex-post presumptive evidence: 2 years? 5 years? 10 years?

    a. Referring to an undefined "*some years after the transaction*" for Tax Authorities to collect as many ex-post data as possible is opening the door to hindsight and increased controversies.

    b. Uncertainty on the outcome of the HTVI value should be balanced with a reasonable burden of proof. In HTVI /IP intensive industries, transfers of HTVI /IP occur quite often, and it would require too much administrative burden to every year gather ex-post data for self-assessment or Tax Authorities' assessment. Therefore, on top of the statute of limitations, the Draft should provide for a limited time-window beyond which ex-post data should not be accepted for presumptive evidence purposes. For example, assuming that the transfer of one HTVI occurred in December 2017, the ex-post data should be dated no later than December 2020.

    c. We do not understand why the OECD claims on Section 10 page 3 that "*nothing in this guidance changes those time limits which are a matter of sovereignty of countries*". Since now the OECD BEPS initiative has been issuing guidance and recommendations that touch the countries' sovereignty, like the scope and content of a Country-by-Country Reporting, the revisions to the Tax treaties, or the thin-capitalisation rules. Why not advocating statutes of limitations specific to the review of HTVIs' valuations?

    d. For example, the OECD could recommend a maximum of 5 years statute or tell the Tax Authorities to rely upon the standard statute of limitations applied to intragroup transactions, however with the limitation that Tax Authorities shall audit an HTVI valuation <u>only once</u> and regardless of the statute of limitations aforementioned, unless taxpayers revise the valuation post-transfer (for example because an unforeseeable event occurred which has materially changed the conditions of the HTVI's exploitation).

    e. Consequently, it is even more advisable that all agreements scoping the related-party transfer of HTVIs shall include a pricing adjustment clause with a time horizon no longer than 3 years (for example to trigger the revision of the valuation (i) in case an unforeseeable event occurred with the consequence of having the actual value of the HTVI deviate by at least 20%, or (ii) at the time of pre-defined milestones for very specific cases of HTVI). Consistently with our previous recommendation, the Tax Authorities would also be entitled to review the approach followed by the taxpayers to amend the value of the transfer.

12. The critical terms "*(un)foreseeable developments or events*" and "*reliable information*" are not defined in the Draft. Further guidance, clarifications and examples would be helpful.

    For example, the OECD could envisage the opportunity to follow the "more likely than not" approach for taxpayers and Tax Authorities to assess the probability of an event, rather than leaving the door open to over-engineered probabilities for any sort of events. The "more likely than not" approach has the advantage of recognizing that the outcome of an HTVI exploitation may generate positive or negative results or "out of the blue" surprises.

    Weighting or factoring all probabilities in the valuation of an HTVI is impossible. On this ground taxpayers will always lose their case before ex-post evidence.

**Recharacterization of transactions and other adjustment provisions**

13. We are firmly opposed to Section 12 on page 4. This section in the Draft is contradicting the OECD's current boundaries to the recharacterization of a delineated transaction under the arm's length principle, and thus is in contradiction with the current outcome of Action Plans 8-10.

14. In the third bullet of Section 13, it needs to be clarified that any revised value cannot be subject to tax unless it is clearly shown that the reason(s) for the different value were reasonably foreseeable/probable at the time of the transfer.

15. We also object to the following statement under Section 23: "*Notwithstanding that the HTVI approach does not apply, an adjustment under other sections of these Guidelines may be appropriate*". Special concepts, as the HTVI is, require special tax provisions. Allowing Tax Authorities to rely upon different grounds across the Transfer Pricing Guidelines in order to reject the valuation of an HTVI (i) raises even more uncertainty on the way the HTVI concept will be implemented, and (ii) diminishes the whole purpose of Chapter VI, Section D4 of the Transfer Pricing Guidelines. Either both Section D4 and the revised Draft should provide end-to-end guidance for HTVIs or both should be removed.

**Examples**

16. While is it clearly understood from Action Plan 8 that the discounted cash flow (DCF) valuation method is only one method to be considered for IP valuation purposes, the prevalence of the DCF in the Draft's examples is striking, and seems to be an implicit indication for Tax Authorities to favour the DCF method, especially for those having limited experience in auditing IP transfers. The mere disclaimer in Section 14 is not sufficient. More examples using other methods than the DCF should be provided.

17. We question the relevance of the pharmaceutical patent as an HTVI in the examples. Considering (i) our knowledge of the pharmaceutical industry that provides numerous third party transfer, alliance, co-development, co-branding, or even joint-venture agreements and (i) the fact that a patent is a kind of "finished" IP whose commercial value is not that "hard" to assess at the time of the patent registration, the qualification of a pharmaceutical patent as "HTVI" is highly debatable and therefore we hardly see the interest of the HTVI

concept (as opposed to the other types of IP) if it even applies to the widest range of IPs available in the market.

18. Considering the variety of industries impacted by the Draft, it is unclear to us why all examples are related to the pharmaceutical industry.

19. Finally, as indicated above, tangible examples of what an HTVI is or is not would be appreciated.

*****

We kindly ask you to take our comments and proposals into due consideration.

Yours sincerely

**SwissHoldings**
Federation of Industrial and Service Groups in Switzerland

Dr. Gabriel Rumo
Stv. Vorsitzender der Geschäftsleitung

Martin Hess
Stv. Leiter Steuern, Dipl. Steuerexperte

cc - SwissHoldings Board

# TAX EXECUTIVES INSTITUTE, INC.



29 June 2017

Jefferson Vanderwolk
Tax Treaties, Transfer Pricing and Financial
Transactions Division
Centre for Tax Policy and Administration
Organisation for Economic Co-Operation
and Development
Paris, France

**Via email: transferpricing@oecd.org**

**RE: Implementation Guidance on Hard-to-Value Intangibles**

Dear Mr. Vanderwolk:

The Organisation for Economic Co-Operation and Development (OECD) published final reports pursuant to its base erosion and profit shifting (BEPS) project in October 2015. The reports were the culmination of the OECD's *Action Plan on Base Erosion and Profit Shifting* (hereinafter the Plan), which it published in 2013. The Plan set forth 15 actions the OECD would undertake to address a series of issues that contribute to the perception of tax bases being eroded or profits being improperly shifted.

Included in the October 2015 final reports was the report under Actions 8-10 of the Plan, entitled *Aligning Transfer Pricing Outcomes with Value Creation*. The OECD subsequently released a discussion draft pursuant to Action 8 on 23 May 2017, regarding *Implementation Guidance on Hard-to-Value Intangibles* (the Discussion Draft or Draft) and requested comments from stakeholders. I am pleased to respond to the OECD's request for comments on behalf of Tax Executives Institute, Inc. (TEI).

**<u>TEI Background</u>**

TEI was founded in 1944 to serve the needs of business tax professionals. Today, the organization has 56 chapters in Europe, North and South America, and Asia. As the preeminent association of in-house tax professionals worldwide, TEI has a significant interest in promoting tax policy, as well as the fair and efficient administration of the tax laws, at all

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levels of government. Our nearly 7,000 individual members represent over 2,800 of the leading companies in the world.[1]

**<u>TEI Comments</u>**

General Comments

TEI commends the OECD for the implementation guidance on hard-to-value intangibles (HTVI) provided in the Discussion Draft. As the OECD is well aware, transfer pricing issues surrounding HTVIs present a myriad of problems for taxpayers and tax administrators alike. In particular, TEI commends the OECD for its statements in paragraphs 31 and 32 of the Discussion Draft on the importance of resolving the double taxation of income through the mutual agreement procedure (MAP) available under most bilateral tax treaties. TEI recommends that the OECD strengthen the language in these paragraphs to further heighten the awareness of the availability of the MAP process to resolve disputes, as well as the importance of the elimination of double taxation to an effective, efficient, and certain tax system.

As a threshold matter, it would be useful if the guidance in the Discussion Draft included a list of features that indicate what is *not* considered an HTVI. While what is and is not considered an intangible asset has been the subject of much discussion before and during the BEPS project, with many definitional issues still unresolved, it would assist taxpayers and tax authorities in applying the Discussion Draft guidance to have some direction on when an intangible might be considered an HTVI or, alternatively, when it should not be so considered. Even a short list of factors would be helpful in this area.

TEI acknowledges the 2015 Final Report for Actions 8-10 of the BEPS project recommended, *inter alia*, the materiality measurement and time periods contained in the current exemptions be reviewed by 2020 in light of further experience, as noted in Paragraph 4 of the Draft. In the light of this commitment, TEI recommends that in the interim the OECD provide additional detailed guidance related to these exemptions, as many multi-national enterprises (MNEs) will address these issues in the immediate future.

In addition, we note that a high degree of subjectivity will inevitably be applied to an HTVI analysis, particularly as actual outcomes will be available on audit by tax authorities. Thus, TEI recommends any guidance intended to establish a common understanding amongst tax administrations and provide for consistent application of the HTVI approach be sufficiently detailed to ensure proposed adjustments are based on arm's length data available contemporaneously with a particularly transaction, rather than purely through hindsight.

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[1] TEI is a corporation organized in the United States under the Not-For-Profit Corporation Law of the State of New York. TEI is exempt from U.S. Federal Income Tax under section 501(c)(6) of the U.S. Internal Revenue Code of 1986 (as amended).

Guidance related to HTVI should also include more clarity on the relationship with other published guidance, including the recently updated OECD commentary on transactional profit splits of anticipated profits. We anticipate that there will be overlap in the two areas so additional guidance should address any links to ensure consistency and clarity.

Paragraph 5 of the Discussion Draft refers to the concern of many tax authorities of information asymmetries between taxpayers and tax administrators. TEI recommends the OECD provide guidance in this area by introducing an element of "proportionality" into any efforts to address this issue. Such guidance should include materiality thresholds so that the proportionality of efforts to remedy any information asymmetries is tied to the size of a specific transaction. Taxpayers do not have the benefit of hindsight when making business decisions and assessing business risk. Taxpayers must make investment and operational decisions with the information available to them at the time and do not, and indeed are generally prohibited from, adjusting transfer prices retroactively based on hindsight if, for example, the taxpayer has erroneously overvalued an intangible. TEI recommends that the Discussion Draft acknowledge this point to assist tax authorities' understanding of the *ex ante* informational constraints MNEs face when making business decisions and setting transfer prices.

The guidance in the Discussion Draft also addresses the requirement to assess what conditions would have been established *ex ante* at arm's length. However, it appears the language included in the Discussion Draft, which references paragraph 6.192 of the OECD Transfer Pricing Guidelines, creates a significant risk that the guidance in the Draft will be interpreted as permitting tax authorities to choose a different pricing method *ex post*. TEI strongly recommends that this language – as well as similar language contained in Paragraphs 13 and 28 of the Discussion Draft – be clarified to avoid tax administrations arriving at this incorrect interpretation.

In addition, there is little current guidance on how far back in time tax authorities may use hindsight to assess the need for an HTVI adjustment. To provide some measure of certainty, the guidance should recommend countries' statutes of limitation that would allow tax administrations reasonable time to collect the appropriate information on which to base a potential pricing adjustment and provide taxpayers with a sufficient amount of certainty, but that after this date has passed, the earlier years would be treated as permanently closed for further adjustments.

TEI also recommends the OECD make clear the guidance in the Discussion Draft is only applicable prospectively to taxpayers and transactions taking place sometime after the OECD issues guidance in final form. That is, the guidance should explicitly bar retroactive application of the new rules by tax authorities to past transactions. This would permit taxpayers to adjust their operations and transfer prices to the new guidance and ensure taxpayers are not subject to double taxation under contracts and transfer pricing approaches that were in place before the new rules. Prospective application of the rules would also increase tax certainty for taxpayers and tax authorities. This would be in accord with the OECD's and International Monetary Fund's (IMF) recent focus on the impact of tax certainty – and uncertainty – on cross-border trade and investment.[2] TEI agrees with the OECD and IMF that certainty in tax matters is a critical consideration for MNEs when determining whether to enter a particular market and other strategic business decisions.

Comments Regarding Examples in the Draft

While TEI welcomes the examples in the Discussion Draft, the examples are too simplistic and unidirectional to provide thorough guidance to taxpayers. TEI recommends the final version of the Draft include additional examples that reflect the complexity of business transactions, facts, and circumstances.

For example, TEI suggests that an additional example could be included as follows. The facts would be the same as in Example 1, paragraphs 17 and 18 of the Draft. In addition, sales from the intangible are assumed to be:

| | |
|---|---|
| Year 4/Actual Sales: | 200 |
| Year 5/Actual Sales: | 400 |
| Year 6/Actual Sales: | 800 |
| Year 7/Estimated Sales: | 1200 |
| Year 8+/Projected Sales: | 1500 |

In year 7, the tax authorities of Country A conduct an audit of years 4-6, obtain year 7 estimates, and years 8+ projections. The OECD should then explain what data can or should Country A tax authorities use to estimate the arm's length value of the intangible in year 0. Should such data be only the actual numbers (*i.e.*, the *ex post* results) or all of the information available, including estimates and revised future projections? Similarly for the estimate of arm's length value by tax authorities in Country S.

In addition, there should be at least one example where Country S tax authorities (tax authorities of the country purchasing the intangible) are conducting an audit and find the price paid in Year 0, or the royalty rate calculated in Year 0, exceeded the arm's length price. These tax authorities may have an interest in making a transfer pricing adjustment to either disallow the purchase price amortization or royalty rate exceeding the arm's length price, and/or assert that a constructive dividend took place that requires payment of a withholding tax.

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[2] *See*, *e.g.*, Tax Certainty: IMF/OECD Report for the G20 Finance Ministers, March 2017 *available at* https://www.oecd.org/tax/tax-policy/tax-certainty-report-oecd-imf-report-g20-finance-ministers-march-2017.pdf (noting "the importance of providing greater tax certainty to taxpayers to support trade, investment and economic growth").

Finally, a couple examples illustrating the coordination of the statute of limitations and use of *ex post* outcomes to determine transfer prices would be helpful. This would be particularly useful for situations involving lump sum payments and royalty payments.

**Conclusion**

TEI appreciates the opportunity to comment on the Discussion Draft regarding implementation guidance on hard-to-value intangibles. These comments were prepared under the aegis of TEI's European Direct Tax Committee, whose Chair is Nick Hasenoehrl. If you have any questions about the submission, please contact Mr. Hasenoehrl at +41 786 88 3772, nickhasen@sbcglobal.net, or Benjamin R. Shreck of the Institute's legal staff, at +1 202 464 8353, bshreck@tei.org.

Sincerely yours,
TAX EXECUTIVES INSTITUTE, INC.

Janice L. Lucchesi
*International President*

TP&C
Transfer Pricing & Controlling

Organisation for Economic Cooperation and Development
**c/o Tax Treaties, Transfer Pricing and Financial Transactions Division**
2 rue André Pascal
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26 June 2017

**Via email: TransferPricing@oecd.org**

Dear Sirs

**Request for Input on Discussion Draft on BEPS Action 8 - Implementation Guidance on Hard-to-Value Intangibles**

We appreciate this opportunity to contribute some general thoughts to the important Discussion Draft on the implementation of the guidance on Hard-to-Value Intangibles ("HTVI").

The use of ex post data as presumptive evidence for non-arm's length transfer pricing is arguably one of the most 'potent' anti-avoidance tools placed at the disposal of tax authorities in the realm of transfer pricing. Unambiguous guidance on the appropriate utilization of such a tool is thus of great importance. From the perspective of taxpayers and consultants the most vital concern is an appropriate limitation of the utilization of ex post data by tax authorities. In other words, the guidance on implementing the HTVI approach needs to establish clear provisions against the misuse of hindsight by tax authorities.

Unfortunately, the scope of the discussion draft appears to be somewhat constrained and falls short of providing clarification in terms of safeguards against the use of hindsight. Various issues within Section D.4 of Chapter VI that would merit a more comprehensive discussion, are not touched upon in detail. Specifically, the exemptions to the application of the HTVI approach contained in paragraph 6.193 are simply assumed as being non-applicable in the context of the examples featured in the Discussion Draft. Considering that the question of whether these exemptions are applicable will likely be a contentious issue in future tax audit proceedings, providing respective examples would have been welcome. Hopefully, the responses to the Discussion Draft will address these concerns and facilitate a broader discussion.

Comments on the specific examples:

*Example 1, Scenario A*

The core issue in this scenario is arguably to be seen the threshold or burden of proof applied. The fact that the taxpayers' inability to "demonstrate that such a development was unforeseeable" is assumed to trigger the transfer pricing adjustment based on presumptive evidence implies a rather unpragmatic threshold. Taxpayers will seldom be able to demonstrate a specific development to have been in fact “unforeseeable”, rather than perhaps “unlikely”. At this point, it would have been sensible to explicitly refer to the preconditions for qualifying for exemptions stipulated in paragraph 6.193, i.e. the case study should have addressed the question of what kind of evidence would generally be considered suitable to provide reliable evidence (ex post). In the case at hand, it would seem sensible to regard an evaluation of whether the likelihood of a commercialization period of three years would have been factored into negotiations between unrelated parties. In a first step, either an analysis of external data on commercialization of drugs in a similar therapeutic category and stage of development as well as an analysis of internal data on similar transaction would seem reasonable. In case it is determined that a commercialization period of three years is rather unlikely (i.e. < 10%), it would seem reasonable to assume that third parties would either not have included the possibility of such a short commercialization period in their respective negotiations or would have only attributed minor importance (weight) on this aspect. Given such circumstances, no adjustment should be applicable, irrespective of the ability of the taxpayer to demonstrate that such a development was unforeseeable or that it was adequately considered in the originl valuation.

Further, an explicit cross-reference to paragraph 6.186 would have been welcome. Specifically, the practical implications of applying specialized knowledge, expertise and insight into the business environment merit further discussion. Considering that the current guidance is based on the rather simplistic assumption that the tax authorities may not have the specific business insights or access to the information to be able to examine the taxpayer’s assumptions should have been qualified. In this context, it should be clarified that tax authorities would have to consider the economic rationale for the shortening the commercialization period. In case the shortening of the period could be traced-back (i.e. by appropriate documentation) to successful strategic decisions and corresponding investments (i.e. hiring additional researchers or re-allocating other resources to the commercialization of the drug) made by Company S after concluding the transaction with Company A, it is not clear why this should justify an ex post adjustment of the purchase price, i.e. why should Company A benefit from the entrepreneurial actions made by Company S? In case tax authorities argue that respective strategic decisions would have been known in Y O, the burden of proof should rest with the tax authorities rather than the taxpayer. In any case, the additional expenses made by Company S in the effort to shorten the commercialization period should be accounted for when revising the original calculations made by the taxpayer

An intriguing element of a more general nature is that the tax authorities would not have been able to evaluate the reasonableness of the anticipated sales in Y 0, even in case all the relevant information would have been available (discussion point 18). It is not clear, whether this inability also applies to an evaluation of the reasonableness of the anticipated commercialization period. The question here is, whether information asymmetry really exists in this scenario. It seems questionable whether the preconditions (paragraph 6.191) for applying presumptive evidence (paragraph 6.192) can be regarded as being fulfilled. It appears further unsustainable to work on the default assumption that information asymmetry will generally be prevalent and exacerbate the difficulty for tax authorities to assess the arm’s length nature of transfer prices. It should rather be recognized that in the context of intangibles taxpayers will also make their decisions based on incomplete information – just as unrelated parties. The use of presumptive evidence must not penalize taxpayers for making decisions under uncertainty, i.e. this is an aspect which should be included in a more detailed discussion on paragraph 6.193.

*Example 1, Scenario B.*

This example illustrates that the application of a threshold is sensible. Comparatively minor differences between financial projections and outcomes do not merit closer inspection and should not trigger adjustments based on presumptive evidence.

In the context of HTVIs a reasonable confidence interval (i.e. 80%) will often encompass a broad range of expected future cash flows – i.e. there will be a rather high probability of failure and volatility within the confidence interval can be assumed to exceed 20% of expected cash flows. At this point in time, allowing for a 20% deviation from the expected value is certainly welcome as a safe-harbor-type threshold. When reviewing the exemptions and thresholds in 2020 (discussion point 4), it should, however, be considered to derive the applicable threshold from a more transparent (empirical) process (e.g. utilizing an analytical framework based on Monte Carlo Simulations for sales forecasts).

*Example 2*

The assertion that it is commensurate with the arm's length principle to recover the underpayment in year 3 rather than in year 0 is sensible. Such a payment reflects an adjustment mechanism that is indeed often agreed between unrelated parties in case a high degree of uncertainty prevails (note: German transfer pricing regulations on business restructurings contain similar provisions). It must be clarified, however, that taxpayers should be free to stipulate adjustment mechanisms that are suitable for each individual transaction. In case a respective adjustment mechanism is agreed upon, tax authorities would obviously be entitled to evaluate the arm's length nature of the mechanism and the applied parameters.

The crucial aspect of Example 2 is, however, the excessive powers granted to tax authorities in respect to adjusting the transfer price in later years – even in case that the transaction involving HTVIs was subjected to previous audits. Clearly, in case that the arm's length nature is confirmed (i.e. not challenged) in a previous audit, the tax authorities should not be entitled to utilize presumptive evidence in subsequent years – as the assumption of information asymmetry exacerbating the difficulty for tax authorities to assess the arm's length nature of the agreement must be rejected. Hence, an adjustment during the subsequent audit for the years 3-5, based on presumptive evidence gained in year 7, should not be feasible in case the arm's length nature of the agreement was audit and confirmed in for years 0-2.

For taxpayers, the envisioned implementation would translate into a disproportionate degree of uncertainty.

*Example 3*

Again, similar to Example 2, in case an audit was already conducted for the years 0-2 an adjustment should not be feasible based on ex-post evidence. In case of a license arrangements, it must be sufficient to constrain the power to evoke adjustments to future periods, particularly as a systematic erosion of the tax base appears highly unlikely – i.e. excessive anti-avoidance tools are not required.

Closing Remarks

The Action Point 8, including the new analytical framework based on the DEMPE functions, constitutes a vital step towards modernizing the arm's length principle. The new guidance will likely contribute a closer alignment between value added contributions and profit allocation, i.e. effectively curtailing highly aggressive tax planning structures. While the effects of the revised guidelines will take some time to manifest in empirical evidence, it would seem prudent to implement the guidelines in a way that gives taxpayers the benefit of the doubt. Regarding HTVIs, granting tax authorities discretionary powers to use ex-post data should thus be limited, i.e. by providing sensible safe-harbor-type thresholds and discouraging adjustments in case that the transaction involving a specific HTVI was subjected to a prior audit.

Please do not hesitate to contact us if you have any questions.

Yours sincerely

Dr. Oliver Treidler

UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS

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**VIA EMAIL**
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**Re: OECD Discussion Draft on BEPS Action 8 Implementation Guidance on Hard-to-Value Intangibles**

Dear Mr. VanderWolk,

USCIB[1] appreciates the opportunity to comment on the discussion draft on BEPS Action 8 Implementation Guidance on Hard-to-Value-Intangibles ("HTVI Guidance" or "the implementation guidance").

General Comments

USCIB welcomes the statement that the approach with respect to HTVI in the Final Report for Actions 8-10 and this discussion draft are consistent with the arm's length principle, although we are concerned that in application the HTVI Guidance can lead to non-arm's length results.[2] We also welcome the recognition that the HTVI Guidance does not permit tax administrations to simply 'true up to actuals", rather any adjustments must reflect the **probability** of the actual outcome, not just the actual outcome.

USCIB also supports consistent application of the transfer pricing guidelines, so we strongly support reaching a common understanding and practice among tax administrations. To that end and given the subjective nature of the standards, the implementation guidance should be more detailed. Because of the potential for tax administrations to interpret the definition of HTVI broadly, it is likely that there will be a significant number of cases and that many taxpayers and transactions will be swept into this

[1] USCIB promotes open markets, competitiveness and innovation, sustainable development and corporate responsibility, supported by international engagement and prudent regulation. Its members include top U.S.-based global companies and professional services firms from every sector of our economy, with operations in every region of the world. With a unique global network encompassing leading international business organizations, USCIB provides business views to policy makers and regulatory authorities worldwide, and works to facilitate international trade and investment.

[2] Discussion draft paragraph 2.

guidance. It is, therefore, important that there be additional guidance with respect to the scope of these provisions, taxpayers' ability to contest whether the intangibles involved in their transactions are within the scope of HTVI, and more guidance related to the exemptions in order to avoid clearly non-arm's length results. In addition, the discussion draft lacks critical guidance to protect taxpayers. The final guidance should include guidance on what needs to documented by taxpayers and what level of detail is expected in the financial information provided by taxpayers.

Detailed Comments

Paragraph 1 states that the Action 8 "mandated" the development of transfer pricing rules or special measures for transfers of HTVI. The term "mandated" overstates the commitment to providing such rules as stated in the Actions 8-10 Final Report.

Paragraph 2 provides: "the taxpayer has the possibility to rebut such presumptive evidence by demonstrating the reliability of the information supporting the pricing methodology adopted at the time the controlled transaction took place." It is unclear from this statement whether only the information needs to be contemporaneous or whether the taxpayer needs to provide contemporaneous documentation. While the taxpayer should be required to comply with the tax administration's normal transfer pricing documentation requirements, we believe the ex post presumption in favor of tax administrations' HTVI adjustments should permit the taxpayer, for purposes of rebutting the HTVI adjustment, to use contemporaneous information that was not available to the taxpayer at the time of the transaction. In addition, the discussion draft does not provide guidance on the types of evidence and level of detail that taxpayers should provide to demonstrate the ex ante valuation was reliable. Such guidance would help taxpayers to provide evidence in line with the expectations of tax administrators. This point is discussed further below.

USCIB also believes that, before the taxpayer is required to rebut the presumption applicable to HTVI adjustments, the taxpayer should have the opportunity to contest the assertion that the transaction is subject to the HTVI rules. Paragraph 6.189 of the Final Report, includes as part of the definition of a HTVI, the standard that no reliable comparables exist. If, for example, contemporaneous comparable transactions are discovered subsequent to the transaction, or contemporaneous facts provide evidence that the projections should not be considered unreliable, these comparables and facts should exclude the transaction from the application of the HTVI rules and deny the presumption to the tax administration. Comparables may exist for methodology as well as value.

Paragraph 2 also provides that "ex post evidence should not be used without considering whether the information on which the ex post results are based could or should reasonably have been considered by the associated enterprises at the time the transaction was entered into." This seems to imply that ex post evidence should not be used if it could not have been considered on an ex ante basis. USCIB supports this reading of paragraph 2 and would like the final guidance to clarify this point.

USCIB agrees with the statement in paragraph 4 that it is important to consider the practical aspects when evaluating the application of the rules as part of the 2020 review.

Paragraph 6 should be applied symmetrically and cover cases where actual income or cash flows are both significantly higher and significantly lower than projected.

USCIB would like to re-emphasize the importance of the last sentence in paragraph 6:

> It would be incorrect to base the revised valuation on the actual income or cash flows without also taking into account the probability, at the time of the transaction of the income or cash flows being achieved.

Ex post outcomes should not be the basis for an adjustment to the transaction. It is also important to note, that a sample of one (the actual outcome) is generally uninformative of the ex ante average.

USCIB agrees with the statement in paragraph 7 that "tax administrations may, in appropriate circumstances use ex post outcomes to consider the appropriateness of the projections and probability weightings taken into account in the valuation at the time of the transaction." This seems to state that ex post outcomes assist with the evaluation of the ex ante price, but do not substitute for it. USCIB strongly agrees with this statement and interpretation. The key flaw in the implementation guidance is that there is no guidance on how tax administrations should use the ex post results to consider the appropriateness of projections and probability weightings. In the absence of such guidance (including the possible use of formulas, (see, regulations under 1.482-7) USCIB is concerned that tax authorities may make arbitrary adjustments to the projections and probability weightings that will lead to non-arm's length results.

*Timing*

USCIB agrees with the statement in paragraph 7 that tax administrations should apply audit practices to ensure that HTVI transactions are identified and acted upon as early as possible. Tax administrations need to balance their ability to perform risk assessment and evaluate the reliability of information with taxpayers' need for tax certainty. Countries should have statutes of limitation which preclude audits going back an excessive number of years. Statutes of limitation may reasonably vary based on the features of the transaction or taxpayer behavior (willful misstatements or omissions or fraud). However, in the absence of special circumstances, there ought to be a point at which the tax administration can no longer raise an issue and adjustments can no longer be made; tax years ought to close.

As the discussion draft points out[3], timing issues should not be overstated. Audit cycles may occur well after the close of the year and ex post outcomes may be available at that point.

Another aspect of timely resolution of issues relates to upfront methods of dispute resolution. The Final Report for Actions 8 -10 explicitly provides that concluding a bilateral APA with respect to the transfer of the intangible constitutes an exemption from the HTVI rules. A bilateral APA is the "gold standard" for upfront dispute resolution. Because the reason for the HTVI is information asymmetry in favor of the taxpayer, the discussion draft should encourage other upfront methods of engaging with taxpayers. Tax authorities should consider the possibility of addressing HTVI under cooperative compliance regimes

[3] Paragraph 9.

and other methods that provide governments with information upfront, so that the taxpayer can share the available information, discussing their evaluation of the relevant risks, thereby reducing information asymmetry, and creating the possibility of reaching early agreement.

*Alternative Pricing Structures*

Alternative pricing structures relate to the timing issue. If a taxpayer structures a transaction as a lump sum payment, then the time for adjusting that lump sum payment may expire before outcomes may be known. If the pricing structure is converted to a contingent royalty, then it will be possible to make prospective adjustments to that royalty for open later years.[4] USCIB believes that the tax administrations should not be able to use alternative pricing structures to avoid statute of limitations expect in exceptional cases.

The discussion draft reiterates portions of paragraph 6.192, but omits part of that paragraph that USCIB believes is important. We believe it is important to include the following statement in the final version of the implementing guidance:

> Where the tax administration is able to confirm the reliability of the information on which *ex ante* pricing has been based, notwithstanding the approach described in this section, then adjustments based on *ex post* profit levels should not be made.

This guidance is critical both because the implementation guidance may function as a "mini tool-kit", and it is therefore important that this concept be clear in the toolkit. Second, applying the HTVI rules to a transaction may frequently result in the recharacterization or nonrecognition of the transaction. The general guidance under the Final Report on Actions 8 – 10 requires that the transaction be accurately delineated before it is priced. Nevertheless, the guidance provides a high bar for non-recognition of the transaction as structured by the taxpayer:

> The non-recognition of a transaction that possesses commercial rationality of an arm's length arrangement is not an appropriate application of the arm's length principle.[5]

USCIB believes that the way to interpret the general guidance and the HTVI guidance consistently is to apply the HTVI rules in a two-step process. First, if a transaction is determined to be hard to value, then the tax administrations may look at ex post evidence to price that transaction (including the time limits related to pricing that transaction). Second, if the ex ante pricing would be commercially irrational because the information on which it was based was unreliable and the uncertainty was not properly reflected in the probabilities assigned at the time of the transaction, then the tax authorities may both look at ex post evidence and recharacterize the transaction (convert the lump sum payment to a contingent royalty). The transfer pricing guidelines provide a high-bar for non-recognition of a

[4] If the tax authorities convert a lump sum payment to a contingent royalty, then the tax authorities should be required to price the contingent royalty in accordance with the new risk profile. A lump sum payment is riskier for the licensee, than a contingent royalty. Therefore, if tax administrations change the form of payment, then the price determined for the restructured transaction will be consistent with the arm's length standard, if and only if, the price is determined in line with the reduced risk associated with the contingent royalty.
[5] Final Report Actions 8 -10, paragraph 1.123.

transaction, because non-recognition of the transaction as structured and recharacterization of the transaction as something else is much more likely to lead to conflicts between tax administrations. If the tax administrations see two different transactions, then it is much more likely they will disagree on the price and much more likely that there will be double taxation.

A reliable ex ante valuation will price both the possible upsides and the possible downsides. Financial projections are not designed to predict the actual outcome of a transaction; they are designed to average all possible future outcomes to ensure an arm's length price at the time a transaction occurs.[6]

Ex post outcomes are just-one time outcomes; a single realization out of a large number of possible outcomes. So, even if the ex post outcome was a possible outcome that the taxpayer took into account in its ex ante calculation (and assigned a probability to), the ex ante pricing also recognizes that every other outcome that we did not observe ex post could have occurred with some probability. That is the reason USCIB completely agrees with paragraph 6 of the discussion draft which provides: "It would be incorrect to base the revised valuation on the actual income or cash flows without also taking into account the probability, at the time of the transaction of the income or cash flows being achieved."

Basing the adjustment on the observed ex post outcome as presumptive of the ex ante probability-weighted average would thus be equivalent to assigning a probability of one to that ex post outcome in the ex ante probability-weighted average and a probability of zero to every other possible outcome. That would clearly be a non-arm's length benefit of hindsight result. We therefore support that statement at paragraph 6 but although it is helpful to tell tax administrations they cannot do something fundamentally inconsistent with the arm's length principle, it would be more helpful to tell tax administrations how they are supposed to use ex post evidence to assess the ex ante probability that was assigned by the taxpayer to that ex post outcome in the ex ante pricing. The final guidance should encourage tax administrations to provide formulas that would place limits on the ability to adjust the ex ante price based on the ex post results. The OECD should consider looking to guidance provided under the U.S. transfer pricing regulations, in particular guidance under section 1.482-7 may provide useful guidance.

The ex ante price would therefore have to differ from the price that would be paid if the outcome were known in advance (or the price that would be determined based on 20/20 hindsight, which of course should not be the result under the HTVI guidance). The commercially rational behavior is to price the transaction, before the outcomes are known, on the likelihood of those outcomes occurring (regardless of the relative likelihood of the option), not based on the actual outcome of the transaction. When the language from paragraph 6.192 is omitted from the implementation guidance, the connection between the unreliability of the information and the commercial irrationality of the transaction is missing and may lead to inappropriate application of the HTVI guidance.

The first exemption from application of the HTVI guidance requires both reliable ex ante projections and:

[6] The OECD hard-to-value intangible guidance, Philippe Penelle, International Tax Review, April 2017.

> Reliable evidence that any significant difference between the financial projections and actual outcomes is due to: a) unforeseeable developments or events occurring after the determination of the price that could not have been anticipated by the associated enterprises at the time of the transaction; or b) the playing out of probability of occurrence of foreseeable outcomes, and that these probabilities were not significantly overestimated or underestimated at the time of the transaction;[7]

Assuming that there are no unforeseen events, it is difficult to see how a taxpayer could satisfy the first part of the test – requiring "details of the ex ante projections used at the time of the transfer to determine the pricing arrangements, including how risks were accounted for in calculations to determine the price (e.g. probability-weighted), and the appropriateness of its consideration of reasonably foreseeable events and other risks, and the probability of occurrence" – and not satisfy the second half of the test. That is, if the taxpayer demonstrates that it appropriately weighed the probability of reasonably foreseeable events and other risks on an ex ante basis, how could the outcome not be the playing out of the occurrence of those reasonably foreseeable events? What additional information could the taxpayer provide? Would the tax authorities need to demonstrate that the taxpayer ignored foreseeable risks or weighed the risks inappropriately?

If one is attempting to determine probabilities, in some cases there will be only a finite number of possible outcomes, this would be true in, for example, a horse race or a coin toss. There are not, however, a finite number of outcomes in the case of the potential outcomes of business transaction with respect to an intangible; the outcomes will essentially represent an infinite number of points on a continuum. Taxpayers cannot consider all these points. Some may be of the same order of magnitude and grouped and others may be too remote to consider. Taxpayers will build pessimistic, average, and optimistic scenarios and assign probabilities to these scenarios based on their prior experience. The question for taxpayers is whether tax administrations will consider these projections sufficient to satisfy the requirements for the exemption or whether they will require more granularity. If more granularity is required, how much granularity is enough given that the possibility of an infinite number of outcomes. It is important for there to be guidance on this in advance, otherwise it will be extremely difficult for taxpayers to satisfy a requirement that may always remain just out of reach. In the absence of a bilateral APA, an upfront discussion pursuant to a cooperative compliance program might help with defining the appropriate parameters of this exercise.

It would also be helpful to provide some guidance on basic probability theory, and its application to transfer pricing, which is frequently misunderstood. Assuming they are independently distributed, the likelihood of a string of events occurring is the product of the separate likelihood of each event. The likelihood of getting heads four times in a row on four straight coin tosses is 6.25 percent (.5 x .5 x .5. x .5), but the likelihood of the fourth coin toss coming up heads once there have been three heads in a row is 50 – 50. The successful development of an intangible may require a successful outcome on a series of different risky steps. Thus, the probability of the entire string of events being successful must be considered in total taking into account the mathematical interaction of those probabilities. It is important that hindsight not distort the perception of the risk because it ignores the interplay between

[7] Final Report Actions 8 – 10, paragraph 6.193(i)(2).

the risks.  As discussed below, it might make sense to expand the examples and this aspect of probability theory could then be illustrated in an example.

The probability of an event is different from whether it is unforeseeable.  There are some events which are foreseeable in a general sense, but which may be difficult to predict with any certainty.  Some examples of these are business cycles and the development of new competing products.  There will be upswings and downswings, which are not unforeseeable in the abstract, but may be extremely difficult to predict when they occur.

*Examples*

USCIB believes that the examples do not provide guidance on the practical application of these rules.  The examples provide a new price for the transactions, but provide no basis for how the adjustments were computed.  In the absence of principle or objective guidance, there will be no common understanding; adjustments may be inconsistent and arbitrary; and adjustments will likely be contrary to the arm's length standard.

Because the exemptions are critical to the proper application of the guidance, the examples need to illustrate the concepts discussed above, in particular, how one would evaluate whether the initial projections including probabilities was reasonable and how one would support that based on the ex post outcomes.  The examples should include an illustration of the components for a successful rebuttal.

The examples start from the assumptions that: 1) there are no reliable comparables and 2) the projections for future cash flows are highly uncertain.[8] The examples then use the income method for determining the transfer price. The facts of the examples lead to the conclusion that the income method is not the best transfer pricing method.  Paragraph 6.163 of the Final Report for Actions 8 – 10 provides: "the reliability of a valuation of a transferred intangible using discounted cash flows valuation techniques in dependent on the accuracy of the projections of future cash flows or income on which the valuation is based."  Thus, by using the income method as the basis for the tax administration's adjustment, the examples in the discussion draft seem to contradict the Final Report.  How this is intended to work should be clarified.

The examples do not clarify that reaching a value for the transfer in year zero requires analyzing both projected income and the discount rate.

There are no examples on how a taxpayer would demonstrate that something was unforeseeable (other than the natural disaster mentioned in the Action 8 -10 Final Report).  Is there a distinction between unforeseeable events and difficult to predict events?  Even natural disasters are foreseeable in the sense that hurricanes, earthquakes and volcanic eruptions (like business cycles and the development of competing products) will occur.  The unknown is the when and where.

*HTVI and the Mutual Agreement Procedure*

[8] Paragraph 15.

Given the complexities of resolving HTVI issues across different jurisdictions, USCIB strongly supports permitting the resolution of double taxation cases arising from the application of HTVI through the mutual agreement procedure and the application of the BEPS minimum standard on dispute resolution to such disputes. USCIB believes that footnote 3 is intended to provide that, in order to avoid double taxation, a jurisdiction should make a corresponding adjustment in an open year, even though the year of the primary adjustment may be closed in that jurisdiction. The footnote, however, is confusingly drafted and might be read to permit a jurisdiction to use MAP to open and otherwise closed year to make a primary adjustment. USCIB believes that MAP is not to be used in this way and the footnote should be clarified to eliminate this possible reading.

Conclusion

The implementation guidance needs to provide more detailed, objective guidance. USCIB believes that If one jurisdiction applies the HVTI rules apply to a transaction, then the likelihood of a dispute with the jurisdiction on the other side of the transaction will increase significantly. The availability of MAP is helpful, but there are no guarantees that these issues will be resolved in MAP.[9] Taxpayers also understand the underlying concern with information asymmetry. HTVI, however, solves that potential "wrong" by creating another potential "wrong" (allowing ex-post adjustments not firmly grounded in the arm's length standard). That outcome should be avoided. In order to avoid that outcome, the application of HTVI should be limited by the application of objective standards.

USCIB would be pleased to discuss these issues in more detail.

Sincerely,

William J. Sample
Chair, Taxation Committee
United States Council for International Business (USCIB)

[9] USCIB strongly supports mandatory binding arbitration, which would of course provide more certainty. For the time being, however, MBA is the exception rather than the rule.