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BEPS Action 8: OECD Issues Discussion Draft on Hard-to-Value Intangibles

The Organization for Economic Cooperation and Development (OECD) on 4 June released a non-consensus discussion draft on Action 8 of its base erosion and profits shifting (BEPS) plan regarding hard-to-value intangibles. Interested parties are invited to submit comments to the OECD by 18 June, and a public consultation on this and other transfer pricing topics will be held 6-7 July at the OECD Conference Center in Paris.

The discussion draft updates the current language in Chapter VI of the 2010 version of the OECD's transfer pricing guidelines relating to aspects of hard-to-value intangibles (this language was bracketed and shaded in the 2014 BEPS report, Guidance on Transfer Pricing Aspects of Intangibles). The proposed new guidance focuses on Option 1 of Part II of the discussion draft on revisions to Chapter I of the transfer pricing guidelines issued 19 December 2014, dealing with transfer pricing rules or special measures for hard-to-value intangibles (HTVI). Option 1 introduced the ability for tax administrations to use, under certain circumstances, ex-post results of an intangible transfer as presumptive evidence that taxpayers would have adopted contingent payment mechanisms.

Arm's length pricing when valuation is highly uncertain at time of transaction

The discussion draft states that, when valuation of an intangible or rights in an intangible at the time of the transaction is highly uncertain, and questions arise as to how arm's length pricing should be determined, the questions should be answered by reference to what independent enterprises would have done "to take account of the valuation uncertainty."

According to the discussion draft, there are a number of pricing arrangements that independent parties may agree upon, depending on the facts and circumstances. In cases when subsequent developments are sufficiently predictable to make forecasts reliable, independent parties may use projections of anticipated benefits to fix a price (*ex ante* pricing) at the outset of the transaction, regardless of the eventual outcome of the benefits. In other cases, independent parties might conclude that pricing based on anticipated benefits alone does not provide adequate protection against the risks posed by the high uncertainty in valuing the intangible. In those cases, independent parties might:

- Adopt shorter-term agreements;
- Include price adjustment clauses in the agreement;
- Adopt payment structures involving periodic milestone payments;
- Adopt a royalty rate set to increase as the licensee's sales increase; or
- Agree to renegotiate the pricing arrangement if major unforeseen developments occur, changing the fundamental assumptions on which the pricing was determined.

The discussion draft states that if independent parties would have adopted price adjustment clauses, tax administrators should be permitted to determine pricing based on such clauses.

The discussion draft identifies the difficulties tax authorities face in verifying the developments or events the parties could or should have taken into account when the pricing was determined. It suggests that information asymmetry between tax authorities and businesses regarding the business and its environment may give rise to a risk of systematic mispricing.

Hard-to-value intangibles

The discussion draft sets out features for HTVI that may be subject to special considerations. HTVIs are intangibles for which, at the time of their transfer between group companies, (i) no sufficiently reliable comparables exist; and (ii) there is a lack of reliable projections of future cash flows or income expected to be derived from the transferred intangible, or the assumptions used in valuing the intangible are highly uncertain.

Intangibles that fall within the category of HTVIs may exhibit one or more of the following features:

- Intangibles that are only partially developed at the time of the transfer;
- Intangibles that are not anticipated to be exploited commercially until several years following the transaction;
- Intangibles that separately are not HTVI but that are connected with the development or enhancement of other intangibles that fall within the category of HTVI; and
- Intangibles that are anticipated to be exploited in a manner that is novel at the time of the transfer.

The situations that may exhibit attributes of HTVIs may encompass a broad range of intangibles, making the guidance in the discussion draft potentially applicable to many intangible transfers.

The discussion draft proposes that, when there is a transfer of HTVIs and there is a significant difference between ex post outcomes and ex ante projections, tax authorities may impute contingent arrangements that use actual results in years subsequent to the transfer. However, when the tax authorities are able to confirm the reliability of the forecast information on which the pricing has been based, price adjustments based on actual outcomes should not be made. The discussion draft includes a specific exception whereby a review of actual outcomes should not affect pricing used by the business if the business provides (i) full details about the forecasts used in the pricing calculation; and (ii) satisfactory evidence that any significant difference between the financial forecasts and actual outcomes was due to unforeseeable developments. Examples of unforeseeable developments include the unexpected bankruptcy of a competitor or a natural disaster occurring after the transaction.

Comments

Although the discussion draft does not use the term “commensurate with income,” the conceptual framework discussed in the guidance appears to be similar to the U.S. commensurate with income concept and periodic adjustments rules.

Because the motivation for the guidance provided in the discussion draft relies on the asserted information asymmetry between taxpayers and tax administrations, taxpayers are not likely to be able to rely on the guidance to make self-initiated ex-post-based adjustments to their results. This issue has been, and still is, controversial under U.S. rules.

There are several areas in which additional clarification would be helpful, including the following:

- The discussion draft states that the benefit of hindsight should be used only to adjust ex-ante pricing in situations when significant differences between financial projections and actual results exist. The inclusion of U.S.-style safe harbors requiring the deviation between ex ante and ex post results to be greater than 120 percent or less than 80 percent of the expected ex ante value may be helpful in reducing uncertainty.
- The inclusion of additional examples allowing assessment of ex post outcomes, such as unanticipated macroeconomic events (recessions, depressions, or greater than expected economic growth) and unforeseen governmental actions may be helpful.
- Limits in time from the date of the original transaction for the application of the special considerations appear reasonable. For example, it would not be appropriate to look back 15 years to test a transaction, except in situations involving extremely long development periods.
- Additional clarification as to what the words “partially developed,” “several years following the transaction,” and “novel” mean with respect to the situations that may reflect HTVI considerations to limit the potential situations in which special considerations would be helpful.

- The discussion draft is silent on whether contingent price clauses included in agreements will be respected, thereby permitting taxpayers to make positive and negative adjustments to their initial valuations without the aid of the mutual agreement process. Clearly permitting such clauses would help reduce uncertainty.
- Whether the proposed changes are considered special measures outside of the arm's length standard or consistent with the arm's length standard. The initial sections of the discussion draft appear to make the case that the changes are within the arm's length standard, similar to the U.S. commensurate with income rule. However, commentators may disagree. If the special considerations do not reflect the arm's length principle, amendments to double tax treaties would be required for them to be effective (both to article 9 of the OECD model treaty and to bilateral tax treaties, which could be achieved through the proposed multilateral instrument under the BEPS project).

On an OECD webcast on 8 June, Marlies de Ruiter, head of the OECD's Tax Treaty, Transfer Pricing, and Financial Transactions division, announced the OECD would not release an updated version of the discussion draft on revisions to Chapter I. Additional information on the revisions to Chapter I and guidance on other BEPS actions will be provided at the OECD conference to be held 10-11 June in Washington DC, or at the OECD consultation in Paris 6-7 July.

Tax Analysis is published for the clients and professionals of the Hong Kong and Chinese Mainland offices of Deloitte China. The contents are of a general nature only. Readers are advised to consult their tax advisors before acting on any information contained in this newsletter. For more information or advice on the above subject or analysis of other tax issues, please contact:

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