

Base Erosion and Profit Shifting (BEPS)

Public Discussion Draft

BEPS Action 8

Implementation Guidance on Hard-to-Value Intangibles

23 May-30 June 2017



THE APPROACH TO HARD-TO-VALUE INTANGIBLES: IMPLEMENTATION GUIDANCE FOR TAX ADMINISTRATIONS

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, contained in the 2015 Final Report for Actions 8-10, "Aligning Transfer Pricing Outcomes with Value Creation" ("BEPS TP Report") and already formally incorporated to the Guidelines. Section D.4 of Chapter VI addresses the treatment of HTVI for transfer pricing purposes. This 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. At the same time, 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.

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 discussion draft also includes a final section explaining the interaction between the HTVI approach and the access to the mutual agreement procedure under the applicable Treaty.

Interested parties are therefore invited to send their comments on this discussion draft. Comments should be sent by **30 June 2017** at the latest by email to TransferPricing@oecd.org in Word format (in order to facilitate their distribution to government officials). They should be addressed to the Tax Treaties, Transfer Pricing and Financial Transactions Division, OECD/CTPA.

Please note that all comments on this discussion draft will be made publicly available. Comments submitted in the name of a collective "grouping" or "coalition", or by any person submitting comments on behalf of another person or group of persons should identify all enterprises or individuals who are members of that collective group, or the person(s) on whose behalf the commentator(s) are acting.

The proposals included in this discussion draft do not, at this stage, represent the consensus views of the CFA or its subsidiary bodies but are intended to provide stakeholders with substantive proposals for analysis and comment.

THE APPROACH TO HARD-TO-VALUE INTANGIBLES: IMPLEMENTATION GUIDANCE FOR TAX ADMINISTRATIONS

1. Introduction

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

2. The outcome of this work is found in Section D.4 of the Revised Chapter VI of the Transfer Pricing Guidelines, 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 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 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" (paragraph 6.188). 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, 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. There are a number of additional exemptions that, where the conditions governing those exemptions are met, render the approach inapplicable. Importantly, where the approach applies, a tax administration is entitled to use, in evaluating the *ex ante* pricing arrangements, the *ex post* evidence about financial outcomes to inform the determination of the arm's length pricing arrangements that would have been made between independent enterprises at the time of the transaction (see paragraph 6.192). However, the *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 (see paragraph 6.188).

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.

4. The BEPS TP Report also states 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 the light of further experience.

5. 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.

6. The HTVI guidance aims at providing an answer for tax administrations to this problem. In the case of intangibles which fall within the definition of HTVI found in paragraph 6.189, and under certain conditions, tax administrations are entitled to consider *ex post* outcomes as presumptive evidence about the appropriateness of the *ex ante* pricing arrangements. 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.

7. The nature of the approach to HTVI inevitably requires some consideration of timing issues. Tax administrations should apply audit practices to ensure that HTVI transactions are identified and acted upon as early as possible. 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. 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.

8. The elapsed time between the transfer of the HTVI and the emergence of *ex post* outcomes may not always correspond with audit cycles or with administrative and statutory time periods. This problem may be more acute for intangibles that have a long incubation period – that is, the period after the transfer and before the intangible can be exploited commercially and income can be derived (see paragraph 6.190).

9. The impact of timing issues should not be overstated since there is already a time lag in typical audit cycles. For example, assume an audit of Years 1-3 is carried out in Year 5; during the course of the audit, the tax administration may identify not only a transfer of a hard-to-value intangible in Year 1 but also *ex post* outcomes of that transfer that may be evaluated during the audit process. Tax administrations should be encouraged to identify transfers of potential HTVI, to evaluate the assumptions made by the taxpayer in valuing the intangible, and to seek information about developments that lead to *ex post* outcomes which may call into question those assumptions, even when those outcomes arise in years subsequent to those under audit, in order to be in a position to consider the appropriateness of the *ex ante* pricing.

10. This guidance for tax administrations on implementing the approach to HTVI should not be used to delay or bypass normal audit procedures. In fact, it remains important to identify transfers of HTVI as early as possible and to act on presumptive evidence promptly as a matter of good administrative practice, and in order to avoid running into difficulties with administrative or statutory time limits for audits and reassessment. Nothing in this guidance changes those time limits, which are a matter of sovereignty of countries.

11. Some countries may encounter difficulties in implementing the HTVI approach due, for example, to short audit cycles or a short statute of limitations. This guidance does not require countries to adopt legislation aimed at overcoming such difficulties, but it does not prevent countries from considering

targeted changes to procedures or legislation (such as the introduction of a requirement to notify promptly the transfer or licence of an intangible falling within the HTVI definition, or amendment of the normal statute of limitations).

12. In implementing the HTVI approach contained in Section D.4 of Chapter VI, 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.

13. Some of the practical ways in which the approach to HTVI can be applied are illustrated in the examples in the following section. The application of the approach to HTVI should be underpinned by the following principles:

- Where the HTVI approach applies, tax administrations can consider *ex post* outcomes as presumptive evidence about the appropriateness of the *ex ante* pricing arrangements.
- The *ex post* outcomes inform the determination of the valuation that would have been made at the time of the transaction; however, it would be incorrect to base the valuation on the actual income or cash flows without taking into account the probability of achieving such income or cash flows at the time of the transfer of the HTVI.
- Where a revised valuation shows that the intangible has been transferred at undervalue or overvalue compared to the arm's length price, the revised value of the transferred intangible may be assessed to tax taking into account contingent payments and price adjustment clauses, irrespective of the payment profiles asserted by the taxpayer, consistently with paragraph 6.192.
- Tax administrations should apply audit practices to ensure that presumptive evidence based on *ex post* outcomes is identified and acted upon as early as possible.

2. Examples

14. The following examples are aimed at illustrating the practical implementation of a transfer pricing adjustment arising from the application of the HTVI guidance. The assumptions made about arm's length arrangements and transfer pricing adjustments determined in the examples are intended for illustrative purposes only and should not be taken as prescribing adjustments and arm's length arrangements in actual cases or particular industries. The HTVI guidance must be applied in each case according to the specific facts and circumstances of the case.

15. These examples make the following assumptions:

- The transaction involves the transfer of an intangible (or rights therein) meeting the criteria for HTVI in paragraph 6.189, that is (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.
- The exemptions to the application of the HTVI approach contained in paragraph 6.193 are not applicable unless specifically discussed.

- As a result, the HTVI guidance is applicable and the tax administration may consider *ex post* outcomes as presumptive evidence about the appropriateness of the *ex ante* pricing arrangements.
- A transfer pricing adjustment is warranted for the transaction.

16. In addition, the examples make reference to valuation techniques using the discounted value of projected income or cash flows derived from the exploitation of the transferred intangible. Such a valuation approach is discussed in Chapter VI paragraphs 6.153-6.178. References to such a valuation technique should not be interpreted as implying conclusions about the appropriateness of the technique in a particular case.

2.1 Example 1

17. Company A, a resident of Country A, has patented a pharmaceutical compound. Company A has concluded pre-clinical tests for the compound and has successfully taken the compound through Phases I and II of the clinical trials. Company A transfers in Year 0 the patent rights to an affiliate, Company S, a resident of Country S. Company S will be responsible for the Phase III trials following the transfer. In order to determine the price for the patent on the partially developed drug, the parties made an estimation of expected income or cash flows that will be obtained upon exploitation of the drug once finalised over the remaining life of the patent. Assume the price so derived at the time of the transfer was 700 and that this was paid as a lump sum in Year 0.

18. In particular, the taxpayer assumed sales would not exceed 1,000 a year, and that commercialisation would not commence until Year 6. The discount rate was determined by referring to external data analysing the risk of failure for drugs in a similar therapeutic category at the same stage of development. Even if the tax administration of Country A had been aware of these facts relating to the transfer of the patent rights in Year 0, it would have had little means of verifying the reasonableness of the taxpayer's assumptions relating to sales.

Scenario A

19. In Year 4, the tax administration of Country A audits Company A for Years 0-2 and obtains information that commercialisation in fact started during Year 3 since the Phase III trials were completed earlier than projected. Sales in Years 3 and 4 correspond to sales that were projected, at the time of the transfer, to be achieved in Years 6 and 7. 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.

20. 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 1,000 instead of 700. Therefore, assume for the purposes of the example that the arm's length price anticipated in Year 0 should have been 1,000. Note that the value of 1,000 is not necessarily the net present value of the transferred rights based solely on the actual outcome (see paragraph 6 of this implementation guidance).

21. In accordance with the approach to HTVI, the tax administration is entitled to make an adjustment to assess the additional profits of 300 in Year 0.

Scenario B

22. 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. Note that the value of 800 is not necessarily the net present value of the transferred rights based solely on the actual outcome (see paragraph 6 of this implementation guidance).

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. 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.

Example 2

24. The facts are the same as in paragraphs 17-18. Based on those facts, assume that in Year 7, the tax administration of Country A audits Company A for Years 3-5 and obtains information that sales in Years 5 and 6 of the product to which the patent relates were significantly higher than those projected. In the original valuation, the taxpayer had not projected sales any higher than 1,000 in any year, but outcomes in each of Years 5 and 6 show sales of 1,500. 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.

25. The tax administration uses the presumptive evidence based on the *ex post* outcome to determine that the possibility of higher sales should have been taken into account in the valuation. 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).

26. In accordance with the approach to HTVI, the tax administration is entitled to make an adjustment to assess the additional profits of 600. Assume for the purposes of this example that none of the exemptions listed in paragraph 6.193 of Chapter VI of the Guidelines applies.

27. One way to implement the adjustment is to re-assess the price paid in Year 0. 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 payment structure might protect against subsequent developments that are not sufficiently predictable (see 6.183 of Chapter VI of the Guidelines).

28. Pricing arrangements for the transfer of intangibles in comparable circumstances observed in the same business sector may point to appropriate alternatives to making the adjustment in Year 0. For example, assume that 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. In this case, assume that the first market approvals were obtained in Year 3. 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. Note 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 for the transfer of a particular type of intangible.

29. The principles illustrated by this example apply irrespective of whether the tax administration in fact carries out an audit for Years 0-2 and then a second audit for Year 3-5, or whether it audits only for Years 3-5. In both scenarios, a revision to the original valuation is justified based on *ex post* evidence emerging in Year 7, and the undervaluation may be recovered based on the HTVI approach contained in Section D.4 of Chapter VI (see paragraph 6.192).

Example 3

30. The concepts illustrated by Example 3 apply where there has been no initial lump sum payment and the arrangement is structured by the taxpayer as a recurring royalty over the term of the agreement. Assume that the royalty has been derived by the taxpayer in the same way as the lump sum payment in Example 1. The expected income or cash flows have been estimated to arrive at the value of the intangible transferred, but then the value is recovered through a periodic royalty payment based on a percentage of anticipated sales. Therefore, assume that Company A has estimated a value of 700 and that the net present value of sales over the period of the agreement is 3500, and that accordingly a recurring royalty payment as a rate of 20% on sales has been determined. Assume also that the tax administration determines on an audit of Years 3-5 in Year 7, as described above, that the Year 0 value was 1300, with the result that the royalty rate should have been higher in all years. The amount of the primary adjustment to be assessed and of the corresponding adjustment to be granted in open years will be determined in accordance with the domestic law of each country and the rules on statute of limitations applicable to these transactions¹. Exemption (iii) in paragraph 6.193 of Chapter VI of the Guidelines may apply if the amount of compensation actually recovered on the basis of the pricing arrangements determined at the time of the transaction -a royalty rate of 20% of sales- does not differ by more than 20% from the compensation anticipated at the time of the transaction (because, for example, the royalty rate has been applied to earlier and higher sales than projected).

3. HTVI and the Mutual Agreement Procedure

31. The guidance in paragraph 6.195 states that it would be 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 under the applicable treaty.

32. Accordingly, this guidance 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.

¹ 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 endeavour 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.