Public Discussion Draft

BEPS ACTION 8: HARD-TO-VALUE INTANGIBLES

4 June 2015 – 18 June 2015

OECD

BETTER POLICIES FOR BETTER LIVES

DISCUSSION DRAFT ON ARM'S LENGTH PRICING OF INTANGIBLES WHEN VALUATION IS HIGHLY UNCERTAIN AT THE TIME OF THE TRANSACTION AND SPECIAL CONSIDERATIONS FOR HARD-TO-VALUE INTANGIBLES

4 June 2015

Public comments are invited on this discussion draft which deals with work in relation to intangibles under Action 8 ("Assure that transfer pricing outcomes are in line with value creation") of the BEPS Action Plan.

The Action Plan on Base Erosion and Profit Shifting, published in July 2013, identifies 15 actions to address BEPS in a comprehensive manner, and sets deadlines to implement these actions.

Action 8 of the BEPS Action Plan identifies that work needs to be undertaken to develop "transfer pricing rules or special measures for transfer of hard-to-value intangibles."

The 2014 BEPS Report, Guidance on Transfer Pricing Aspects of Intangibles, retained in Section D.3 the current language in the 2010 version of the Transfer Pricing Guidelines relating to aspects of hard-to-value intangibles. However, that guidance was bracketed and shaded to indicate its status as interim guidance, given the close interaction with the work to be done in 2015.

This discussion draft responds to the requirement under Action 8 to develop an approach to hard-to-value intangibles and proposes revisions to the existing guidance in Section D.3 of Chapter VI of the Guidelines.

The revised guidance explains the difficulties faced by tax administrations in verifying the arm's length basis on which pricing was determined by taxpayers for transactions involving a specific category of intangibles. As a result of information asymmetry, it proves difficult for a tax administration to evaluate the reliability of the information on which pricing has been based by the taxpayer. The discussion draft includes an approach based on 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. The approach protects tax administrations against the negative effects of information asymmetry when specific conditions are met. These conditions ensure that price adjustments will only apply where the difference between expected and actual outcomes cannot be explained by considerations other than inappropriate pricing. The approach is therefore necessary to determine the appropriateness of the pricing arrangements for transactions involving these specific intangibles.

The proposed new guidance takes into account the public comments received on Part II of the Public Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (including risk, recharacterisation, and special measures), issued 19 December 2014, and in particular on Option 1 outlining a potential special measure for hard-to-value intangibles.

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

This discussion draft is submitted for comments by interested parties. Comments should be submitted by **18 June 2015** (no extension will be granted) and should be sent by email to TransferPricing@oecd.org in Word format (in order to facilitate their distribution to government officials). They should be addressed to Andrew Hickman, Head of Transfer Pricing Unit, Centre for Tax Policy and Administration. Comments in excess of ten pages should attach an executive summary limited to two pages.

Please note that all comments received regarding 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, or the person(s) on whose behalf the commentator(s) are acting.

A public consultation on the Discussion Draft and other topics will be held on 6-7 July 2015 at the OECD Conference Centre in Paris. Registration details for the public consultation will be published on the OECD website in due course. Speakers and other participants at the public consultation will be selected from among those providing timely written comments on the Discussion Draft.

It is proposed to replace the guidance in Section D.3 of the BEPS Report containing Guidance on Transfer Pricing Aspects of Intangibles with the proposed guidance in this Discussion Draft

D.3. Arm's length pricing when valuation is highly uncertain at the time of the transaction

1. As stated at the outset of this section, Chapter I, Section D contains principles to be considered and a recommended process to be followed in accurately delineating the actual transaction involving intangibles, and in determining whether the guidance on non-recognition applies. When determining the price of a transaction under the principles of Chapter III as supplemented by the guidance in this chapter, intangibles may have specific features complicating the search for comparables and in some cases making it difficult to determine the value of an intangible at the time the transaction takes place. When valuation of an intangible or rights in an intangible at the time of the transaction is highly uncertain, the question arises as to how arm's length pricing should be determined. The question should be resolved, both by taxpayers and tax administrations, by reference to what independent enterprises would have done in comparable circumstances to take account of the valuation uncertainty in the pricing of the transaction.

2. Depending on the facts and circumstances, there are a variety of steps that independent enterprises might undertake to deal with high uncertainty in valuation when pricing a transaction. One possibility is to use anticipated benefits (taking into account all relevant economic factors) as a means for establishing the pricing at the outset of the transaction. In determining the anticipated benefits, independent enterprises would take into account the extent to which subsequent developments are foreseeable and predictable. In some cases, independent enterprises might find that subsequent developments are sufficiently predictable and therefore the projections of anticipated benefits are sufficiently reliable to fix the pricing for the transaction at the outset on the basis of those projections.

3. In other cases, independent enterprises might find 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 such cases independent enterprises might adopt shorter-term agreements, include price adjustment clauses in the terms of the agreement, or adopt a payment structure involving periodic milestone payments to protect against subsequent developments that might not be sufficiently predictable. 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.

4. Also, independent enterprises may determine to bear the risk of unpredictable subsequent developments. However, major unforeseen developments changing the fundamental assumptions upon which the pricing was determined may lead to renegotiation of the pricing arrangements by agreement of the parties where it is to their mutual benefit. For example, a renegotiation might occur at arm's length if a royalty rate based on sales for a patented drug turned out to be vastly excessive due to an unexpected development of an alternative low-cost treatment. The excessive royalty might remove the incentive of the licensee to manufacture or sell the drug at all, in which case the agreement might be renegotiated (although whether renegotiation would take place, would depend upon all the facts and circumstances).

5. If independent enterprises would have insisted on a price adjustment clause, the tax administration should be permitted to determine the pricing on the basis of such a clause. Similarly, if independent enterprises would have considered subsequent developments so fundamental that their occurrence would have led to a prospective renegotiation of the pricing of a transaction, such

developments should also lead to a modification of the pricing of a comparable controlled transaction between associated enterprises.

6. A tax administration may find it difficult to establish or verify what developments or events might be considered relevant for the pricing of a transaction involving the transfer of intangibles or rights to intangibles, and the extent to which the occurrence of such developments or events, or the direction they take, might have been reasonably foreseeable at the time the transaction was entered into. The developments or events that might be of relevance for the valuation of an intangible are in most cases strongly connected to the business environment in which that intangible is developed or exploited. Therefore, the assessment of which developments or events are relevant and whether the occurrence and direction of such developments or events are foreseeable requires specialised knowledge, expertise and insight into the business environment in which the intangible is developed or exploited. In addition, the assessments that are prudent to undertake when evaluating the transfer of intangibles or rights to intangibles in an uncontrolled transaction, may not be seen as necessary or useful for other than transfer pricing purposes by the MNE group when a transfer takes place within the group, with the result that those assessments may not be comprehensive. For example, an enterprise may transfer intangibles at an early stage of development to an associated enterprise, set a royalty rate that does not reflect the value of the intangible at the time of the transfer, and later take the position that it was not possible at the time of the transfer to predict the subsequent success of the product with full certainty. The difference between the ex ante and ex post value of the intangible would therefore be claimed by the taxpayer to be attributable to more favourable developments than anticipated. The general experience of tax administrations in these situations is that they may not have the specific business insights or access to the information to be able to examine the taxpayer's claim and to demonstrate that the difference between the ex ante and ex post value of the intangible is due to mispricing by the taxpayer. Instead, tax administrations seeking to examine the taxpayer's claim are largely dependent on the insights and information provided by that taxpayer. These situations can give rise to a risk of systematic mispricing.

7. In these situations ex post profit levels can provide a pointer to tax administrations about the arm's length nature of the ex ante pricing arrangement agreed upon by the associated enterprises, and the existence of uncertainties at the time of the transaction. If the difference between the anticipated profit levels and the ex post profit levels is not due to unforeseeable developments or events, the difference gives an indication that the pricing arrangement agreed upon by the associated enterprises at the time of the transaction may not have adequately taken into account the relevant developments or events that might have been expected to affect the value of the intangible and the pricing arrangements adopted. This situation should be distinguished from the situation in which hindsight is used inappropriately by not taking into consideration whether information could or should reasonably have been known and considered by the associated enterprises at the time of the transfer.

8. Special considerations are necessary 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 the intangibles involved, and in which situations this is not the case. These special considerations are discussed in the following section, D.3.1.

D.3.1. Hard-to-value intangibles ("HTVI")

9. This section takes into account the matters set out in the first part of section D.3 and outlines approaches which tax administrations may adopt in dealing with a specific category of intangibles, referred to as HTVI. The term HTVI covers intangibles or rights in intangibles for which, at the time of their transfer in a transaction between associated enterprises, (i) no sufficiently reliable comparables exist, and (ii) there is a lack of reliable projections of future cashflows or income expected to be derived from the

transferred intangible, or the assumptions used in valuing the intangible are highly uncertain. As a consequence, ex post information provides presumptive evidence as to the reliability of the information used ex ante in determining the transfer price for the transfer of such intangibles or rights in intangibles.

10. Intangibles falling within the category of HTVI 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 which are connected with the development or enhancement of other intangibles which fall within the category of HTVI;
- Intangibles that are anticipated to be exploited in a manner that is novel at the time of the transfer.

11. For such intangibles, information asymmetry between taxpayer and tax administrations may be acute and may exacerbate the difficulty encountered by tax administrations in verifying the arm's length basis on which pricing was determined. As a result, it will prove difficult for a tax administration to perform a risk assessment for transfer pricing purposes, to evaluate the reliability of the information on which pricing has been based by the taxpayer, or to consider whether the intangible or rights in intangibles have been transferred at undervalue or overvalue compared to the arm's length price, until ex post outcomes are known in years subsequent to the transfer.

12. In these circumstances, the tax administration may consider ex post evidence about the actual financial outcomes of the transfer to be necessary in determining the appropriateness of the ex ante pricing arrangements, and may adopt the approach set out in this section, D.3.1. However, the consideration of ex post evidence should be based on a determination that such evidence is necessary to be taken into account when and in so far as there is no other information to assess the reliability of the information on which ex ante pricing has been based. Where the tax administration is able to confirm the reliability of the information on which ex ante pricing has been based, notwithstanding the special considerations described in this section, then adjustments based on ex post profit levels should not be made. 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. A contingent pricing arrangement is any pricing arrangement in which the quantum or timing of payments or renegotiation provisions are dependent on contingent events, including the achievement of predetermined financial thresholds such as sales or profits, or of predetermined development stages.

13. In order to ensure that this approach is applied only in situations where the difference between ex post outcomes and ex ante projections is significant, and where such a difference is due to developments or events that were or should have been foreseeable at the time of the transaction, its application should be subject to the exceptions set out in the following paragraph.

14. The approach described in this section will apply to the transfer of HTVI as defined in paragraph 9, but will not apply where the taxpayer:

1. provides full details of its 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 comprehensiveness of its consideration of reasonably foreseeable events and other risks; and

2. provides 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 that could not have been anticipated by the associated enterprises at the time of the transaction.

15. As a result, although the ex post evidence about financial outcomes provides relevant information for tax administrations to consider the appropriateness of the ex ante pricing arrangements, in circumstances where the taxpayer can satisfactorily demonstrate what was foreseeable at the time of the transaction and reflected in the pricing, and that the developments leading to the difference between projections and outcomes arose from unforeseeable events, no adjustment to the ex ante pricing arrangements based on these special considerations would be justified. For example, if the evidence of financial outcomes shows that sales of products exploiting the transferred intangible reached 1000 a year, but the ex ante pricing arrangements were based on projections that considered sales reaching a maximum of only 100 a year, then the tax administration should consider the reasons for sales reaching such higher volumes. If the higher volumes were due to for example an exponentially higher demand for the products incorporating the intangible caused by a natural disaster or the unexpected bankruptcy of a competitor that was clearly unforeseen at the time of the transaction, then the ex ante pricing should be recognised as being at arm’s length, unless there is evidence other than the ex post financial outcomes indicating that price setting did not take place on an arm’s length basis.

Additional points

In addition to commenting on the proposed guidance contained in this Discussion Draft, respondents are invited to comment on the following points:

1. Comments are invited on whether there are mechanisms that could be adopted to provide greater certainty for taxpayers regarding the application of the approach to HTVI.

2. Comments are invited on whether any additional exemptions should be added to the exemption contained in paragraph 14 of this Discussion Draft. Where additional exemptions are proposed, commentators should explain how the exemption should be framed, considering the aims of the approach set out in the Discussion Draft.

3. Comments are invited on whether the notion of “significant difference” in paragraph 13 should be defined, and, if so, what mechanisms could be used to determine whether a difference between the ex ante financial projections and the ex post financial outcomes is significant.

4. Comments are invited on what further matters would be useful to consider in any follow-up guidance on practical and consistent implementation of the approach.