BEPS ACTION 8 - IMPLEMENTATION GUIDANCE ON HARD-TO-VALUE INTANGIBLES

PUBLIC DISCUSSION DRAFT

30 June 2017

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.

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]

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.

HTVI, information asymmetry, and *ex post* outcomes

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

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1 See BEPS TP Report, para 6.188.

2 Ibidem, para 6.193.

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.

account, 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.

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.

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.

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

[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).

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).

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]

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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.

[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

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] adjustments 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.

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.

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:

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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).

[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?

Table 2 – 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**

- 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 4,000, and concludes the audit with an assessment for the transfer of the HTVI, equal to Euro 1,000 (see Table 2, below).

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

Table 1 – 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%**

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.

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.

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.

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

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[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.

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:

Hendrik Fügemann	Partner	hef@copenhageneconomics.com
Vincenzo Zurzolo	Senior Economist	viz@copenhageneconomics.com
Claire Foley Danielsson	Senior Economist	clf@copenhageneconomics.com