BEPS Action 8: OECD Recommends use of Hindsight for pricing of Hard-To-Value-Intangibles – Is the Recommendation Flawed?

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1. Opening

Consider the case of an Indian Pharma Company 'I Ltd.' which is developing a drug to cure diabetes. Eight stages of Research and Development (R&D) have to be passed successfully to get from a pharma molecule to a marketable drug. Assume that first two stages of R&D are done in India. Then the molecule is transferred to 'S GmbH', a Swiss Subsidiary of 'I Ltd', for subsequent stages of R&D, because Switzerland is a better location for advance R&D. That is due to availability of qualified scientists, effective IP protections laws, and better R&D infrastructure, in Switzerland.

Say, 'S GmbH' successfully clears the remaining six stages of R&D in next 4 years, after the transfer of molecule by 'I Ltd'. Consequently a new drug for diabetes comes into being. 'S GmbH' becomes the legal owner of the Patent for the newly developed drug. Through licensing of the Patent to various manufacturing entities of the Group - including 'I Ltd.' - 'S GmbH' earns substantial royalties, from 5th year (from the year of transfer of molecule by 'I Ltd.') onwards.

On transfer of molecule by 'I Ltd.' to its Swiss Subsidiary ('S GmbH') the following primary Transfer Pricing issues arise:

i. How do we determine the Arm's Length Price of the molecule?

(*This determination is to be made in these peculiar circumstances*: an early stage intangible like the pharma molecule is a hard-to-value-intangible; the anticipated cash-flows from future exploitation of the pharma drug, if and when developed out of the molecule, are very uncertain; the final success or failure of the R&D is hard to predict at the time when the molecule is transferred.)

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ii. Because of uncertainty in valuation of early stage molecule at the time of its transfer can the Indian Tax Authorities use hindsight, by considering ex-post information of actual income realised by 'S GmbH' from 5th year onwards, to look back and make Transfer Pricing adjustments in case of 'I Ltd.' by disturbing the valuation made at the time of transfer of the molecule?

Last month (on 6th July, 2015) the OECD held Public Discussion on the **Discussion Draft on Hard-To-Value-Intangibles (HTVI)** – the Discussion Draft was released by the OECD on 4th June, 2015 under BEPS Action 8 (HTVI). This Article presents the key features and practical implications of the Discussion Draft, as well as improvements that could be made by the OECD. In course of the Article, answers to the questions posed above will also, hopefully, get unravelled.

2. Key Features of the OECD Discussion Draft on HTVI

Below are the key features of the OECD Discussion Draft on BEPS Action 8 (HTVI).

2.1 What is meant by Hard-To-Value-Intangibles (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[1].

Intangibles falling within the category of HTVI may exhibit one or more of the following features[2]:

- Intangibles that are only partially developed at the time of the transfer; or
- Intangibles that are not anticipated to be exploited commercially until several years following the transaction; or
- 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; or
- Intangibles that are anticipated to be exploited in a manner that is novel at the time of the transfer.

2.2 Why special rules are needed for HTVI?

BEPS Concerns

There are valid BEPS concerns that MNCs are able to erode tax-bases by moving intangibles to low-tax territories. Often MNCs arbitrarily transfer intangibles under development (which subsequently generate a very substantial income stream) at an undervalued price to a Subsidiary domiciled in a low-tax jurisdiction, and then shift there substantial amount of the income derived from the intangibles. Such a wrongful practice has been pointed out as one of the root causes of Base Erosion and Profit Shifting (BEPS). Nations need to devise measures against abusive arrangements of this kind.

Information Asymmetry

Further, Transfer Price of intangibles is generally set on basis of valuation e.g. Discounted Cash Flow valuation.The Discussion Draft argues that it is difficult for a Tax Authority to evaluate the reliability of information used by a Taxpayer to price a HTVI given the information asymmetry between Tax Authorities and Taxpayers. Information asymmetry exists when (*i*) the Taxpayer has more information than is available to the Tax Authorities and (*ii*) the incremental information has an impact upon pricing.

2.3 Due to Information Asymmetry the Tax Authorities may use benefit of hindsight

To get over the difficulty posed by information asymmetry a Tax Authority may consider -in

hindsight - ex post evidence about actual financial outcomes, to gauge the reasonableness of the ex-ante transfer price set by the Taxpayer.

The use of ex-post evidence in cases involving HTVIs may, however, only be made if the difference between ex-ante *projections* and ex-post *outcomes* is "significant," and where such difference is due to events that were foreseeable at the time of the transaction.

2.4 Tax Authorities may not use hindsight if the Taxpayer proves that variation in Ex Ante valuation and Ex-Post results is due to unforeseeable events

Tax Authorities cannot make hindsight adjustment where the Taxpayer[3] -

i. 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

ii. 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 at the time of the transaction.

2.5 Possible Transfer Pricing Adjustments

As for the determination of what independent enterprises might do, the Discussion Draft notes that independent enterprises may agree to account for highly uncertain valuation in a variety of ways, including:

- Adopting a shorter-term agreement;
- Including price adjustment clauses in the agreement;
- Adopting a payment structure with periodic milestone payments;
- Requiring payment of additional contingent amounts payable on achievement of milestones;
- Requiring additional payments when development targets are achieved;
- Setting a royalty rate to increase as sales of the licensee increase; or
- Renegotiation of the agreement.

On hindsight the Tax Authorities may re-characterise the transaction by including one of the above features in the Transfer Agreement.

After highlighting above the key features of the Discussion Draft, we now look below at the implications of the Discussion Draft.

3. Implications of the suggestions made in the OECD Discussion Draft on HTVI

The Discussion Draft departs from the Arm's Length Principle and introduces Commensurate-with-Income Principle, prescribed in the US TP Regulations for pricing of intangibles. Also, the definition of HTVI is too wide and will capture transfers of almost all intangibles. So there will be large scale adjustments by the Tax Authorities. And that will lead to uncertainty and double taxation.

Various implications are explained below through a Case Study.

3.1 Case Study on Implications

3.1.1 *Facts*

Let us revisit the case of 'I Ltd.' cited in the Opening Para of this Article. After completing initial two stages of R&D 'I Ltd.' transfers the diabetes pharma molecule to 'S GmbH' (subsidiary of 'I Ltd.'). Assume that future income would be 0 (zero) if the molecule fails in subsequent stages of R&D and 100 if the molecule succeeds. Also assume that the probability of both failure and success is equal *i.e.* 50:50. So the transfer price of the molecule is set by the parties at 50, after valuation and negotiation.

3.1.2 *Implications of the OECD Discussion Draft on HTVI*

The molecule will be categorized as HTVI, because it is an early stage intangible – even otherwise almost all intangibles will fall within the scope of HTVI because of the overly broad definition of HTVI.

Note also that there will certainly be significant divergence between the ex-ante valuation (50) and ex-post earnings (either '0' on failure or '100' on success).

A. Implications when the Molecule is successfully developed into a diabetes drug

- When the R&D succeeds the ex-post accrual is 100 while the ex-ante valuation was 50. In view of this significant difference the Transferor ('I Ltd.') has to demonstrate that all foreseeable events were duly considered while valuing the molecule at the time of its transfer.
- And 'I Ltd.' also has to prove that the difference between the ex-ante valuation and ex-post result is due to events unforeseeable at the time of transfer of molecule. But here the difference is not because of any unforeseeable event. Rather the difference is due to initial uncertainty about the success of the molecule at the time of its transfer.
- So how will 'I Ltd.' prove that the ex-ante and ex-post difference is due to an unforeseeable event? 'I Ltd.' will find it hard to do so. Will the Tax Authorities, therefore, make a Transfer Pricing adjustment?
- Because of the significant difference Tax Authorities may contend that the ex-ante valuation was not reliable – authorities may seek to recharacterize the transaction (of transfer of molecule) by imputing a price adjustment clause to the Transfer Agreement.
- The Tax Authorities clearly have the benefit of hindsight which shows that the molecule has been successful. Such benefit was not available to the Taxpayer who had to consider both future scenarios: failure as well as success of the molecule.
- To make Transfer Pricing adjustment the Authorities will have to reopen the assessment. For how many years - after the transfer of molecule and after its development into a successful drug - can the Authorities make ex-post evaluation of actual accruals? Is the time unbounded? No time limit has been prescribed under the current Discussion Draft.
- Will the Swiss Authorities allow co-relative adjustment (by increasing the purchase price in hands of 'S GmbH') to relieve double taxation? Not necessarily.
  - No mechanism is prescribed in the Discussion Draft for resolution of dispute between the two Jurisdictions on application of the HTVI rules.
  - So, there will be double taxation if one Jurisdiction applies the HTVI rules based on hindsight, while the other Jurisdiction decides that those rules do not apply – this risk is real because, *without amendment of Article 9 of Tax Treaties, all Jurisdictions may not agree to apply an ex-post Commensurate-with-Income principle which violates the Arm's Length Principle.*
  - Besides, the Swiss Authorities may contend that the difference of 50 is attributable to functions performed by 'S GmbH', related to the ongoing development, enhancement, maintenance, protection and exploitation of the intangible, subsequent to the transfer of molecule.
  - And so the Swiss Authorities may deny any co-relative adjustment to relieve double taxation.

- The uncertainty caused by taking into account ex-post results will lead to open tax positions for future years in case of 'I Ltd'. As a consequence 'I Ltd.' will find it hard to restructure its business in future even for genuine commercial reasons.

B. Implications when the Molecule fails to develop into a diabetes drug

When the R & D fails no downwards adjustments would be allowed if there are domestic laws similar to section 92(3) of the Indian Income-tax Act, 1961. The Discussion Draft does not explicitly recommend downward adjustment to the transfer price on basis of ex-post information.

4. What the OECD can do to improve its recommendation?[4]

More often than not 'independent parties' transfer HTVI between them based on imperfect future projections; yet the terms of such transfers cannot be revisited subsequently by one party or the other, even though the actual results obtained differ significantly from the original projections. So, generally it is not appropriate to use ex-post information to reconsider and reset ex-ante pricing decisions. But the OECD might still stick with the approach set forth in the Discussion Draft. In that case the Discussion Draft may incorporate the following improvements.

4.1 Provide appropriate Exemption from application of Ex Post hindsight

As the proposed approach is presented as part of the BEPS Project, its application should be restricted to transfers of HTVIs to low-tax jurisdictions. If the Taxpayer can offer rational explanations for deviation from original valuation assumptions, the transaction should not be subject to the ex-post Commensurate-to-Income principle, based on hindsight. This should particularly be the case where –

(*i*) neither of the parties to the arrangement are low functioning entities in low or zero tax jurisdictions; or

(*ii*) where there is an expected incremental pre-tax economic benefit to the Group as a result of the transaction; or

(*iii*) the anticipated *commercial benefits* from sale of the HTVI are significant in comparison to any *tax benefit* in the Transferor and Transferee jurisdiction; or

(*iv*) there are other commercial or non-tax justifications for the transfer.

Additionally, to help it arrive at an ex-ante price, if the Taxpayer uses valuation report prepared by an independent professional valuer – valuation that accords with generally recognised valuation standards such as those published by the International Valuation Standards Council - then that should be an exemption from the approach suggested in the Discussion Draft.

4.2 Tax Authorities should not revisit the Transaction when Profit Split Method is used

With respect to profit splits, the Guidance on Intangibles published in September of 2014 states that the Profit Split Method may be useful in pricing transfers of intangibles, particularly where it is not possible to identify a reliable CUP. See Paragraphs 6.142, 6.145, and 6.199 of the **Guidance on Transfer Pricing Aspects of Intangibles** (Action 8: 2014 Deliverable).

Similarly, the **Discussion Draft on Profit Splits published on December 16, 2014**, states that a *profit split may be reliable for pricing even HTVIs*. See Paragraphs 44 to 49 of the Discussion Draft on Profit Splits. Paragraph 45, in particular, says that a profit split might be a reliable way to address significant differences between ex-ante and ex-post results and that a profit split *"may provide an appropriate way to deal with unanticipated events where strategic risks are effectively shared between associated enterprises."*

Consistent with the above guidance, where a properly constructed profit split is appropriately applied, the Tax Authorities should not revisit the transaction.

4.3 Burden of Proof – Relieve the Taxpayers' Heavy Burden

The Tax Authorities - not the Taxpayers - should bear the burden of proving that price-influencing developments were foreseeable at the time of the transfer.Taxpayers should not be asked to prove that differences between projections and actual results are due to unforeseeable developments and events. Unless the Tax Authority is able to demonstrate that the assumptions or projections did not take into account important foreseeable developments and events, the projections should be respected.

When the Taxpayer provides details of its ex-ante projections, risk assessment, and its consideration of material reasonably foreseeable events and risks, or relies on an independent professional valuation, then the onus should be on the Tax Authority to demonstrate that Taxpayer's projections did not reflect the economic or commercial circumstances prevailing at the time of the transaction.

4.4 Suggest measures for avoidance of Double Taxation

If one Jurisdiction is making an upward adjustment under the BEPS HTVI provisions, then the Jurisdiction on the other side of the transaction must make a downward adjustment and *vice versa*. But the approach suggested in the Discussion Draft is a one-sided approach that does not take into consideration the symmetry of the taxation burden. *It may, therefore, lead to double taxation, as pointed out in Part I (Para 3.1.2.A - seventh Bullet Point).*

Hence it is absolutely critical to ensure a global consensus on offsetting adjustments in the other Jurisdiction. Safeguards must be provided to guarantee that the tax administration in the other State respects an adjustment made by the tax administration in the first State. Preferably, some form of binding conflict resolution – better than MAP - should be introduced.

4.5 Factor in the Developments subsequent to the Transfer

For HTVI *i.e.* intangibles that are transferred at an early stage of development, by definition, there is significant additional development that takes place after the transfer of the partially developed intangible. Subsequent developments carried out by the intangible-purchaser can give rise to deviations from ex-ante projections *vis-a-vis* ex-post results.Where an asset is subject to continuous development, it should be clear that any upside or downside that is due to post-sale development is entirely allocable to the purchasing entity.

So, it is necessary to ensure that at the time of assessing the differences in ex-ante and ex-post profit levels, Tax Authorities recognize the role of parties in developing, enhancing, maintaining, protecting and exploiting (DEMPE) the intangible. The value added by the Transferee, after the transfer of HTVIs, should be eliminated in measuring the difference.

Inconsistent application of these principles by Tax Authorities would lead to double-taxation where the same income is attributed to both the Pre-existing Intangibles (in hands of the Transferor) and to the subsequent DEMPE activities (in hands of the Transferee).

4.6 Lay down Time Limit for Ex Post evaluation and adjustment

The timeframe, within which retrospective adjustment can be possible, should be strictly limited and specified in the guidance. Under the current Discussion Draft the Tax Authorities can evaluate the ex-post results at any point in time after the transfer is undertaken. Leaving this evaluation unbounded by time (and unbounded in number) leaves Taxpayers open to unnecessary uncertainty regarding their tax obligations.

Tax Authorities should not have unlimited jurisdiction to re-evaluate intercompany transactions. Some sort of certainty would be achieved if there is a defined period – a short timeframe, say of 5 years from the date of transfer as per the US TP Regulations – after which no ex-post evidence could be applied by Tax Authorities. It should be recognised that the passage of time reduces the likelihood of a future event being reasonably predicted, and increases the likelihood of divergence between ex-ante projections and ex-post results.

Therefore, tax Authorities should only have a limited duration of time, after a transaction, to apply hindsight based on ex-post results. And if it is once determined that exemption is applicable, then exemption should apply for all points of time in future for the subject intangible.

4.7 Define 'Significant Difference'

In virtually every case ex-ante and ex-post returns will diverge because ex-post results reflect the *realization* of risk and other events rather than their mere *anticipation*. So, it is very important that the proposed guidance does not apply unless there are significant divergences between ex-ante and ex-post results. The OECD should adopt a standard that if the ex-post results are within a specified range of the ex-ante projections, then no adjustment will be made under the HTVI Rules.

The final guidance should, therefore, incorporate easy to apply principles to determine what constitutes a significant difference. The US TP Regulations, for example, lay down a 20 per cent (aggregate actual ex-post profits are less than 80 per cent or more than 120 per cent of the projected ex-ante profits) "significant difference" window. Accordingly, "significant difference" - between ex-ante projections and ex-post outcomes, for application of ex-post evidence – may be set at 20 per cent.

4.8 Prescribe broader category of Unforeseeable or Extraordinary Events

The Discussion Draft allows actual results to differ from projections, so long as those differences arise from unforeseeable events. Two such unforeseeable events (natural disaster and bankruptcy of a competitor) are identified in the Discussion Draft. More such events should be prescribed by the OECD for the benefit of both the Taxpayers and the Tax Authorities. Otherwise, there is concern that Tax Authorities might disagree with events the Taxpayer deems unforeseeable.

Further examples of unforeseeable events that may be prescribed: financial market crises, macroeconomic developments such as recessions and Government actions, greater efficiency or inefficiency of the Transferee, product failures, product recalls, uncertainty of the businesses environment such as unexpected technical innovation, and higher demand arising out of an unexpected popularity of the product.

4.9 Provide Guidance on how the price will be adjusted on hindsight

Ex-post financial data should be used as a pointer only, to assess the reasonableness of the projections and to trigger further enquiry, rather than to straightaway process a transfer pricing adjustment. On adjustment further guidance is needed on how the price will be adjusted; it is currently unclear how the Tax Authorities will determine what should be the alternative hypothetical pricing arrangement. Tax Authorities should not be allowed to easily replace a transaction, or include a contingent payment arrangement, based on the argument that third parties would have structured the transaction that way. Further, guidance is needed on the use of adjustment clauses (milestone payments etc.) recommending that such should be used only when it can be expected in third party situations.

The Discussion Draft indicates several options that might be considered by independent enterprises to deal with various levels of uncertainty. But there is little guidance when to apply which option. Some options (renegotiate, use short term contracts) do not

involve contractual clauses to adjust pricing whereas other options (a price adjustment clause) do. When a price adjustment clause is to be applied there has to be guidance on what that clause should look like.

It must be noted that re-characterizing an HTVI transaction shifts the risk among the different participants to the transaction. Therefore, re-characterization should only be permitted when the initial allocation of risks would not have been agreed by parties at arm's length.

Finally, the guidance seems geared to situations where the transferred asset is more successful than anticipated. There needs to be some explicit reference in the guidelines to symmetry of treatment that ensures that *downward adjustments* are also possible where, for example, a product is less successful than anticipated.

5. What should the Taxpayers do?

The Taxpayers will have to maintain reliable evidence and documentation to demonstrate fair pricing of intra-group transfer of HTVIs. More specifically, the following documentation would be needed to meet the approach laid down in the Discussion Draft.

- Prepare at the outset a cash-flow forecast taking into account all material future scenarios and listing all relevant assumptions made. The assumptions should include economic, commercial and technical assumptions with a range of predicted outcomes. This may be used to prove what was reasonably foreseeable at the outset. Also spell out the underlying assumptions in relation to discount rates, growth rates, useful life of the intangible, material risk factors, and the tax effects of the transaction[5].
- Demonstrate that the pricing arrangements are set based on an appropriate weighting of the foreseeable developments or events that are relevant for the valuation of the intangibles involved. Discard only very low probability events from projections, and that too after documenting why such events have been judged as having very low probability of occurrence in future.
- Independent Valuation, involving independent industry experts, should be done as per prevalent valuation standards. And the projections should be reviewed and approved by either the Executive Committee or Board of the entities involved in the transaction.
- Where subsequent developments are sufficiently predictable and, therefore, the projections of anticipated benefits are sufficiently reliable, the pricing for the transfer of intangible may be set at the outset on the basis of those projections.
- But where the pricing based on anticipated benefits alone does not provide adequate protection against the risks posed by the high uncertainty in valuing the intangible, Taxpayers may adopt shorter-term agreements, include price adjustment clauses in the terms of the agreement, or adopt a payment structure involving periodic milestone payments, as protection against subsequent developments that might not be sufficiently predictable.
- Where possible, establish that the contractual arrangements are consistent with those that would be agreed between unrelated parties. And document that the transfer did not result in a significantly lower effective tax rate. Also maintain satisfactory evidence of the legal and commercial reasons for the transfer.

6. Closing

The guidance provided by the OECD in the Discussion Draft on HTVI released on 4th June, 2015 under the BEPS Action 8 (HTVI) is not yet final. Public comments on the

Discussion Draft have been submitted by various stakeholders. And a Public Discussion too was held on 6th July, 2015. Taking into account the inputs of stakeholders, the OECD is likely to modify the guidance. We can, however, expect modification only on the practical aspects of making the Discussion Draft easier to apply and implement. It means that the basic approach – use of hindsight based on ex-post results – is not likely to change. So the Taxpayers need to watch out for the final guidance. If the OECD makes the necessary changes and improves its guidance on HTVIs, the burden of both the Taxpayers as well as the Tax Authorities will be lightened to some extent.

1. Para 9 of OECD Discussion Draft on Hard-To-Value Intangibles
2. Para 10 of OECD Discussion Draft on Hard-To-Value Intangibles
3. Para 14 of OECD Discussion Draft on Hard-To-Value Intangibles
4. This write up is based on 'Public Comments' and 'Public Discussion' on the OECD Discussion Draft on HTVI, duly supplemented by Authors' own independent analysis.
5. Ref: **Paragraph 6.154 of the BEPS paper,** Guidance to Transfer Pricing Aspects of Intangibles 16 September, 2014