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Mr. Andrew Hickman
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Submitted by Email to transferpricing@oecd.org

18 June 2015

Dear Mr. Hickman

Submission in response to OECD Discussion Draft on Action 8: Hard-To-Value Intangibles

Please find enclosed our submission in response to the Discussion Draft on Action 8: Hard-To-Value Intangibles that was released on 4 June 2015.

The Irish Tax Institute and our members acknowledge the importance of the OECD and tax authorities to implement measures that can prevent or mitigate the impact of abusive tax planning or abusive transactions of certain taxpayers. On behalf of our members, we submit comments in response to the efforts by the OECD to address a challenging technical topic within transfer pricing.

We would like to thank Warren Novis, Jessica Xu and the Transfer Pricing team from KPMG Ireland for their assistance in preparing our submission and gathering input from members in the Irish Tax Institute.

We welcome the insights to be gained from the final Public Consultation and trust that our comments on this Discussion Draft contribute to the debate.

We are available for further discussion on any of the matters raised in our submission.

Yours truly,

Andrew Gallagher

Andrew Gallagher
President
Irish Tax Institute

Andrew Gallagher – *President*, Mark Barrett, Marie Bradley, Dermot Byrne, Colm Browne, Sandra Clarke, Ciaran Desmond, David Fennell, Karen Frawley, Ronan Furlong, Lorraine Griffin, Johnny Hanna, Mary Honohan, Jim Kelly, Aoife Lavan, Jackie Masterson, Tom McCarthy, Frank Mitchell, Martin Lambe *(Chief Executive)*, Kieran Twomey. *Immediate Past President – Helen O' Sullivan*.

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Irish Tax Institute

Response to OECD Discussion Draft:
Hard-To-Value Intangibles

June 2015

About the Irish Tax Institute

The Irish Tax Institute is the leading representative and educational body for Ireland's AITI Chartered Tax Advisers (CTA) and is the only professional body exclusively dedicated to tax. Our members provide tax expertise to thousands of businesses and individuals in Ireland and internationally. In addition many hold senior roles within professional service firms, global companies, Government, Revenue and state bodies.

The Institute is the leading provider of tax qualifications in Ireland, educating the finest minds in tax and business for over thirty years. Our AITI Chartered Tax Adviser (CTA) qualification is the gold standard in tax and the international mark of excellence in tax advice.

A respected body on tax policy and administration, the Institute engages at the most senior levels across Government, business and state organisations. Representing the views and expertise of its members, it plays an important role in the fiscal and tax administrative discussions and decisions in Ireland and in the EU.

Our response

The Irish Tax Institute is writing in response to the Discussion Draft on the Hard-To-Value Intangibles, which the OECD released on 4 June 2015. We prepared this submission with consideration and input from our members.

Overview

One of four components of Action 8 of the OECD's Base Erosion and Profit Shifting ("BEPS") project was to focus on developing rules to price the transfer of hard-to-value intangibles ("HTVI"). We recognise that the Discussion Draft has made efforts to provide clearer guidance on when tax authorities may apply *ex post* evidence to test a transfer of HTVI. However, our concern is that the rules specified in the Discussion Draft will create undue burden on taxpayers to monitor outcomes of a transaction even when a comprehensive business-focused analysis was conducted to price the intangible.

The Irish Tax Institute recognises the importance for tax authorities of obtaining a fair and accurate depiction of the facts based on reliable projections of the business. In principle, the fixed price terms established by taxpayers within a multinational group should be based on the same circumstances routinely affecting uncontrolled parties. That is, all parties are assuming risk by agreeing on a price today where the future value is uncertain.

It is critical that BEPS solutions are framed to prevent abusive transactions without disproportionately creating risk for the majority of transactions which are supported by adequate substance and analysis. A lack of balance in the BEPS recommendations will greatly increase tax disputes and cases of double taxation, and result in overburdened tax authorities and taxpayers. We would recommend a pragmatic approach to avoid placing more pressure on an already burdened dispute resolution process and add further uncertainty to ordinary commercial transactions.

We observed the Discussion Draft was not a consensus document. In order for revised guidelines on transfer pricing to be successful for both taxpayers and tax authorities, broad consensus within Working Party 6 must be achieved prior to new guidelines taking effect.

The general issue with taking *ex post* evidence is that tax authorities may consider to their advantage information which has become known, that was previously unknown to the taxpayer at the time of the transaction. While taxpayers' facts and assumptions are being put to the test in this section of Chapter VI, a fair and balanced view by the OECD is required. That is, tax authorities should be held to the same standard to demonstrate that *ex post* evidence was either known or reasonably foreseeable at the time of the transaction.

Finally, it is in this section where the OECD may wish to consider incorporating quantifiable thresholds to provide a degree of certainty for all stakeholders. We welcomed a proposed change to Chapter VII (Low Value-Adding Services), where paragraph 7.57 indicated a specific range of mark-up between **2% and 5%** as acceptable. We strongly encourage the OECD to continue providing such useful boundaries, in particular in the HTVI section of Chapter VI.

Comments on the Discussion Draft

Consistency with Chapter I, VI and Risk – The transfer of an HTVI for a price is a fundamental transfer of risk from the seller to the buyer. The transfer price reflects an assessment between the parties of the agreed value of the risk. The current revisions to Chapter I and VI of the OECD Guidelines, as they pertain to risk allocation, are not yet finalised. Those revisions are intended to ensure that risk is properly allocated to where the key functions are performed to control and manage that risk. We suggest the OECD considers the impact of such changes on the HTVI rules in Section D.3 of Chapter VI. The HTVI rules currently do not mention risk and risk allocation. It is important that the OECD establishes consistency between the other revisions, and in particular the Risk and Recharacterisation Discussion Draft and the HTVI rules, so that tax authorities do not allocate risk away from where the risk control and management functions are undertaken.

How to Define an HTVI? – Hard-to-Value Intangibles, by their inherent nature, are difficult to define prescriptively to cover all cases. In this respect, the steps by the OECD to define HTVI in Paragraph 9 would therefore provide substantial leeway for tax authorities to deem many intangible transactions as being within the HTVI rules contained in Section D.3 of Chapter VI. Whilst we appreciate the OECD's efforts to provide greater certainty around the types of intangible that could potentially trigger the HTVI rules, the definition of HTVI should be confined to specific types of transactions. In the absence of this, HTVI could be opened to interpretation by tax authorities which could result in transactions being treated as HTVI and consequently re-priced under the proposed rules.

Paragraph 10 of the Discussion Draft identifies features of intangibles that may qualify them as HTVI. We would recommend a more restrictive list of attributes, as opposed to the non-exhaustive list of traits used to determine whether the transaction could be characterised as a HTVI. This would reduce uncertainty and disputes arising over which transactions are in fact HTVI and therefore subject to potential re-pricing using *ex-post* evidence.

Proving Foreseeable vs. Unforeseeable – Paragraph 13 stipulates that tax authorities may only apply *ex post* evidence when the difference between projections and actual outcomes are "**significant**", and when differences are attributed to events that were unforeseen at the time of the transaction. On one hand, we perceive the recognition of unforeseen events as a positive development in the rules (e.g. owing to natural disaster, unexpected bankruptcies, recessions, financial market crashes, etc.), whereby the taxpayer would be deemed to have established an arm's length price. That said, aside major global or regional events, it will be a challenge for taxpayers to evidence, without scrutiny, unforeseeable commercial events that caused divergence between financial projections and actual outcomes. We later request for more guidance on this matter.

Importance of Contemporaneous Documentation and Shifting Burden of Proof – We are extremely concerned about the undue administrative and financial burden caused by a substantial change from the initial guidance set forth in Special Measures – Option 1, in the December 2014 discussion draft on Risk & Capital. In Option 1 (Hard-to-Value Intangibles), the paper cited that an HTVI measure would target the following circumstances where the taxpayer:

1 Fixes the price either as a lump sum or a fixed royalty rate on the basis of projections without any further contingent payment mechanism; **AND**

2 Does not contemporaneously document those projections and make them available to the tax administration.

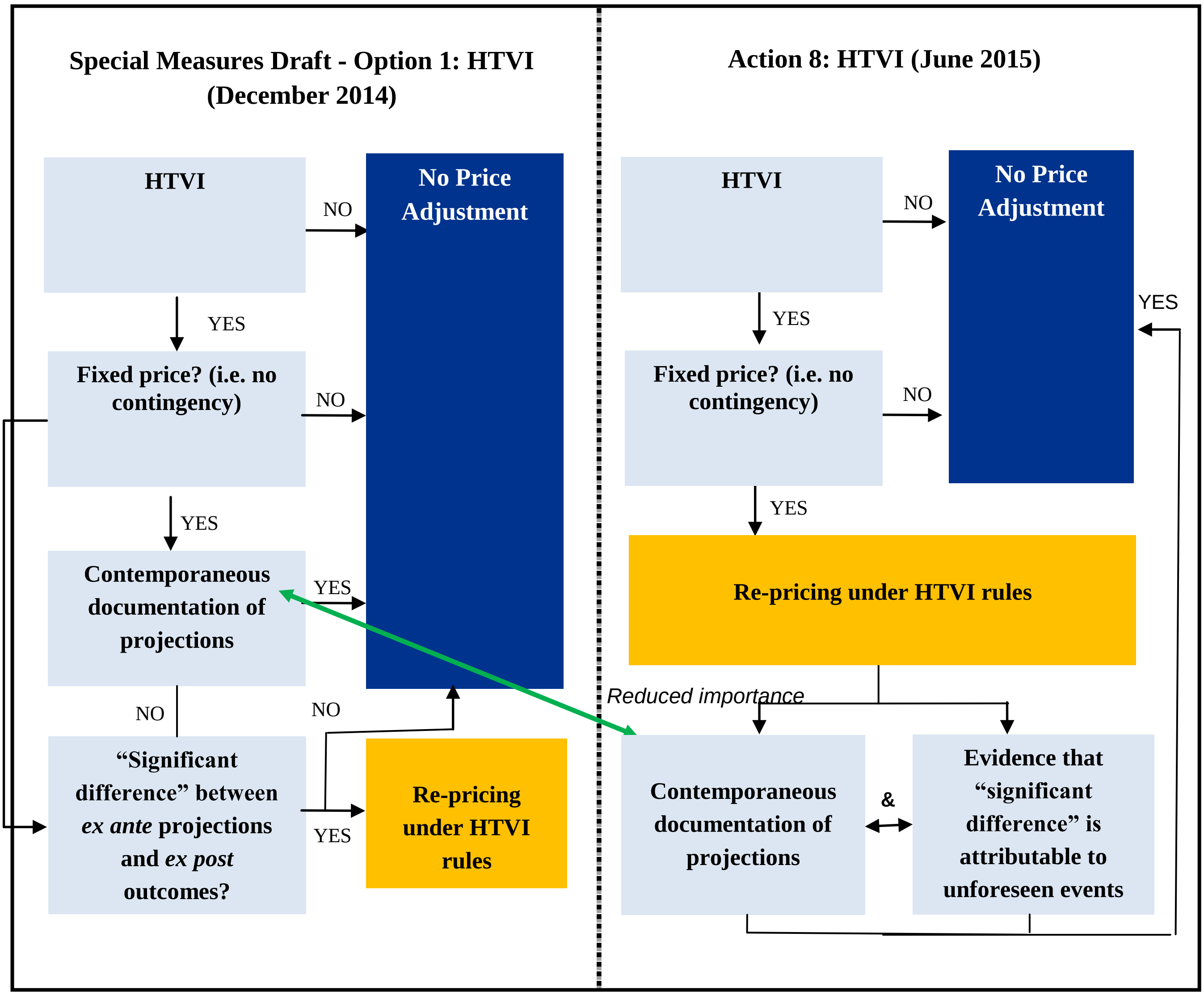
The above language in Special Measures states that the taxpayer must fail both tests in order for the tax authority to be able to apply *ex post* results to re-price the transaction. This is a fair test to apply to the pricing of HTVI.

The Discussion Draft, however, does not appear to place much reliance on the taxpayer's contemporaneous documentation of its *ex ante* projections and assumptions underlying the projections. Rather, the Discussion Draft almost assumes in paragraph 12-13 that differences between the projections and actual results warrant further analysis beyond the contemporaneous documentation, unless the tax authority confirms the reliability of the *ex ante* projections by the taxpayer. This is a much higher standard for the taxpayer to achieve as it is based on the tax authority attaining a comfort level on the transaction.

Paragraph 14 presents two conditions which will exempt a transaction from being re-priced under the proposed HTVI rules. There is an onerous **two-step** requirement for taxpayers to avoid the transaction from being re-priced. Our key concern is the second step, which requires taxpayers to maintain and document "satisfactory evidence" that significant differences between financial projections and actual outcomes were owing to unforeseen events not anticipated at the time of the transaction. There is concern that tax authorities will have a much higher standard of what constitutes "satisfactory evidence", thus leading to numerous challenges on the transaction itself.

The second obligation **should not** exist in tandem with the obligation to contemporaneously document the original transaction. It would not represent arm's length standards for taxpayers to routinely track actual outcomes against original projections, as well as to explain or examine the differences. It is our recommendation that where a taxpayer, in its own view, contemporaneously documents the pricing of its transaction as being arm's length in terms of valuation, terms and conditions, it becomes the tax authority's burden of proof to demonstrate that the arrangement entered into by the taxpayer is not arm's length.

Our recommendation is in effect to re-introduce the conditions that were set out in the Special Measures Option 1, which we have summarised in the diagram below in comparison to the current language in the Discussion Draft.



Special Measures Draft - Option 1: HTVI (December 2014)
HTVI
NO
No Price Adjustment
YES
Fixed price? (i.e. no contingency)
NO
YES
Contemporaneous documentation of projections
YES
NO
NO
"Significant difference" between *ex ante* projections and *ex post* outcomes?
YES
Re-pricing under HTVI rules
Action 8: HTVI (June 2015)
HTVI
NO
No Price Adjustment
YES
YES
Fixed price? (i.e. no contingency)
NO
YES
Re-pricing under HTVI rules
Reduced importance
Contemporaneous documentation of projections
&
Evidence that "significant difference" is attributable to unforeseen events

Contingent Payment and Double Tax – A fixed price arrangement provides simplicity in its nature and an element of certainty to the parties involved. The taxpayer can establish a reasonable estimate of an arm's length price, and tax authorities on both sides of the transaction are able to audit the one-off transaction based on best available forecasts and assumptions.

Paragraph 12 of the Discussion Draft highlights the types of alternative arrangements that could have been entered into to mitigate the uncertainty of a fixed price agreement. Paragraph 12 cites contingent payment arrangements as mechanisms that, if undertaken by arm's length parties, may need to have been an option considered by the taxpayer. Any preference by the OECD toward contingent payment mechanisms may lead to greater double taxation in two distinct ways.

1 Taxpayers may feel the need to price intangibles through contingency mechanisms. When the contingency realises a price adjustment, one tax authority is likely to deny the adjustment while the other advocates for it. Such an approach would likely place the transaction and the parties involved into formal dispute resolution or measures for reciprocity of treatment.

2 Tax authorities may automatically impute a contingency element to a fixed price transaction, and do so when a contingent price adjustment is in its favour, to the disadvantage of another tax authority. This response to the HTVI rules could have an adverse knock-on effect on other non-HTVI transactions to be treated in the same manner where tax authorities impute contingency adjustments on fixed price contracts.

As stakeholders in the evolving state of international tax reform, we are aware of the challenges the OECD is confronting by the attempt to shape HTVI rules since first covered in the Special Measures draft in December 2014. We believe it is crucial that substantial refinement to this Discussion Draft takes place, especially due to the lack of consensus, that and this should be achieved prior to being finalised in September 2015.

Proposed Suggestions to Discussion Draft

We welcome the proposal by the OECD to include in the Discussion Draft an invitation for comments specific to three topics:

(i) Mechanisms to provide greater certainty to taxpayers
(ii) Additional exemptions to supplement paragraph 14
(iii)Notion of "*significant difference*" as noted in paragraph 13.

Mechanisms to obtain greater certainty

Timing – Tax authorities should not have unlimited jurisdiction to re-evaluate intercompany transactions, even if the domestic tax statute permits the tax authority an infinite or extended period to conduct an audit. Greater certainty would be achieved if there were a defined period where after no *ex-post* evidence could be applied by tax authorities and taxpayers would not need to evaluate *ex-post* evidence. The lifetime of many forms of HTVI, such as patents, may have useful economic lives greater than 10 years, which is an administratively long time to track and compare actual to forecast results.

It might be appropriate for the OECD to consider either: (i) pre-existing rules in the United States transfer pricing regulations which imposes a 5 year limitation from the date of the transaction; or (ii) a period reflecting the useful economic life of the underlying assets as defined by generally accepted accounting principles.

Unforeseeable events – The Discussion Draft allows actual results to differ from projections, so long as those differences develop from unforeseeable events. Paragraph 15 identifies two such unforeseeable events (natural disaster and bankruptcy of a competitor). It would be beneficial for both taxpayers and tax authorities for the OECD to list more general instances that it considers unforeseeable events (e.g. financial market crises, product failures/recalls, etc.). Otherwise, there is concern that tax authorities may disagree with events the taxpayer deems unforeseeable.

Relief from Double Tax – A transfer pricing adjustment made by one tax authority to the transfer of an HTVI will present different double tax relief issues, when compared to a transfer pricing adjustment on the license of an HTVI. The Discussion Draft provides guidance on when the tax authority should (and should not) be able to apply *ex-ante* financial results to the price of an HTVI. Additional guidance could be included in Section D.3 of Chapter VI to indicate how the tax authorities should be resolving a Mutual Agreement Procedure matter pertaining to HTVI.

Additional exemption

A particularly important exemption should apply when taxpayers have demonstrated that the HTVI transaction was structured and priced in such a way that is consistent with similar arrangements undertaken by parties dealing at arm's length. We would appreciate exampled guidance on what the OECD would constitute arm's length evidence.

In defining exemptions, it is important to recognise the business purpose of why taxpayers may undertake transfers of HTVI within a group. A key purpose is to centralise ownership, control and decision-making on key intangibles. It is very common that the transfer of an HTVI occurs immediately subsequent to a corporate acquisition, with intangibles residing in the newly acquired company. The purchasing company will ordinarily undertake a commercial valuation of the intangibles prior to making the corporate acquisition for a defined price. The commercial valuation is based on best available projections at the time, and these projections form the basis for the board to authorise funds to make the corporate acquisition.

According to paragraph 12, taxpayers are exempt from HTVI rules "*where the tax administration is able to confirm the reliability of the information on which ex ante pricing has been based*". We suggest paragraph 12 is elaborated to specifically refer to where the taxpayer demonstrates that the financial projections, the data and assumptions are primarily used for non-tax reasons.

Defining "Significant Difference"

Paragraph 13 of the Discussion Draft states that *ex-post* evidence should only be permitted to make adjustments to the price of an HTVI when the difference between *ex ante* projections and *ex post* results is significant.

It is important to note two substantially different types of HTVI scenarios. The first is where the HTVI is valued at a development stage where it is possible zero income may be derived, such as the development being cancelled prior to commercialisation or a product not being approved to be sold to the market. The second is where the HTVI is valued at a stage where income is almost certainly guaranteed, but where the quantum of that income is hard to predict with good accuracy.

In the first case, the value of the HTVI will be based on the relative likelihood of earning some income and earning zero income, akin to a pass-or-fail situation. If each outcome is likely at the time the HTVI is transferred, then the *ex ante* value will be in between zero and a value reflecting the future income. In these cases, it is guaranteed that the *ex post* result will **significantly** differ from the *ex ante* value since the actual value from exploiting the HTVI will be zero or an amount greater than the *ex ante* value. This scenario further demonstrates the importance for Chapter VI to not disregard the importance of comprehensive and timely prepared analyses supporting the *ex ante* valuation at the time, covering the information on assumption of risks and foreseeable events.

In the second case, where the value is uncertain but never going to be zero, both taxpayers and tax authorities will benefit from objectivity in defining this term “significant”. Thus, it is advisable the final guidance incorporates easy to apply principles to determine what constitutes a significant difference. What is significant for one taxpayer may not be for another, taking into account their respective industry, capitalisation, geography, etc.

Notwithstanding our concern on the HTVI rules, we would welcome significance expressed as a **prescribed** percentage of asset value, income of either the seller or purchaser, or other objective measures. In each case, a reasonable range should be considered when developing guidance around this requirement. It may be appropriate to consider pre-existing rules, such as the Cost Sharing Regulations in the United States where the significant difference is defined to be 20% of the price charged for the intangible asset. In order for a taxpayer to manage its risk, this **significant** percentage difference must be consistent across its group in all jurisdictions. If one tax authority were to interpret **significant difference** to be much smaller (e.g. 10%) than the consensus amongst other tax authorities (e.g. 20%), by default, all taxpayers would be required to be concerned with the narrowest interpretation (at 10%) rather than the consensus. Consistent application of HTVI principles is critical to enable management to prioritise transfer pricing analysis and any tracking of the actual results versus forecasts.