
OECD releases guidance for tax administrations on hard-to-value intangibles

August 7, 2018

In brief

The OECD on June 21 released Guidance (the ‘Guidance’) for tax administrations on application of the approach to hard-to-value intangibles (HTVI). The aim of the Guidance is to create a common understanding among tax administrations on how to apply adjustments resulting from application of the HTVI approach, while improving consistency and reducing the risk of double taxation.

The Guidance sets forth the underlying principles that govern the HTVI approach and provides two examples that are intended to assist in clarifying the approach. Finally, the Guidance links the HTVI approach with granting access to the mutual agreement procedure.

The Guidance was mandated under the OECD’s BEPS Actions 8-10 Report - Aligning transfer pricing outcomes with value creation. A public discussion draft was released in May 2017 (see [Tax Insight and Tax Policy Bulletin](#) of June 9, 2017) requesting comments from interested parties on the proposed approach in the discussion draft.

The Guidance confirms the approaches that were presented in the 2017 discussion draft, namely, that in applying the HTVI approach:

- *Ex post* results can be used as presumptive evidence on *ex ante* pricing;
- *Ex post* results are used to be informed on the valuation made at the time of the transaction, while at the same time considering the probability of achieving such results at the time of the transfer of the intangible in question;
- The revised value may be used for tax reassessments, irrespective of payment profiles the taxpayer has put forward; and
- Application of audit procedures in order to identify and act upon HTVI issues as soon as possible.

The Guidance is incorporated in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration as an annex to Chapter VI on Intangibles.

In detail

This Insight discusses the approaches to HTVI that are

confirmed in the Guidance or that have changed compared to the discussion draft published in May 2017.

The Guidance follows up on publication of a discussion draft on May 23, 2017 requesting comments from interested

parties. On the basis of the comments received, the discussion draft was revisited and led to publication of the Guidance.

Background and context

The Guidance finds its origin in the Base Erosion and Profit Shifting (BEPS) project, particularly Actions 8-10: Aligning transfer pricing outcomes with value creation – Intangibles. An HTVI is defined as an intangible for which, at the time of the intra-group transfer, (i) reliable comparables do not exist, and (ii) at the time the transaction was entered into, the projections or future cash flows or income expected to be derived from the transferred intangible, or the assumptions used in valuing the intangibles, are highly uncertain.

Observation: This definition can be construed as being overly broad and may comprehend almost any intangible.

The HTVI approach is aimed at protecting government revenues from profit shifting through tackling the information asymmetry that tax authorities perceive or encounter due to the lack of specific insights in the transaction or the business.

The HTVI approach allows tax authorities to use *ex post* outcomes (higher or lower) as rebuttable presumption on the appropriateness of *ex ante* price-setting. The approach should not be used when:

- details are provided on the *ex ante* projections used upon transfer of the HTVI;
- evidence is given that the significant difference between the *ex ante* and the *ex post* outcomes is due to unforeseeable or extraordinary events;

- the transaction is covered by a bilateral or a multilateral advance pricing agreement (APA);
- the difference between the *ex ante* projections and the *ex post* outcomes is less than 20%; or
- five years of commercialization have elapsed since the year in which the HTVI first generated third-party revenue for the transferee

Implementation guidance

The Guidance repeats to some extent the purpose of the HTVI approach. The approach should be applied in a manner that promotes tax certainty for taxpayers and reduces the risk of double taxation.

The Guidance discusses respectively timing issues, audit and adjustments made, and dispute prevention and resolution. The application of the approach is illustrated through two examples, each containing two different scenarios.

Timing issues

The Guidance recognizes that the time between the HTVI transaction and the emergence of the *ex post* outcomes does not necessarily correspond with the audit cycles used or even with the administrative or legal time periods (statute of limitation issues). At the same time, the Guidance warns that such timing issues should not be overstated, as regular audit cycles usually already contain a certain time lag. Tax authorities are encouraged to identify and act upon HTVI transactions as early as possible.

Note: The application of the Guidance on the HTVI approach does not change any time limits.

Audit issues

The Guidance indicates that tax authorities should use audit practices

to identify HTVI transactions and react as early as possible. At the same time, the Guidance mentions that it may be difficult to perform a risk assessment at the time of the transactions or shortly thereafter. The HTVI guidance should not be used to delay or circumvent the normal audit procedures under domestic law.

Appropriate adjustments

The Guidance repeats that the HTVI approach allows tax authorities to make appropriate adjustments – including adopting alternative or different pricing structures for the transaction, such as milestone payments, running royalties, price adjustment clauses, or a combination of pricing structures. Because no reliable comparable intangibles exist in case of HTVI, references to pricing structures used in transactions between unrelated parties likely will not be available.

Observation: The Guidance stops short, however, in indicating how and on what basis a tax authority should make such pricing adjustment and therefore could be subject to subjective interpretation and to arbitrariness.

Dispute prevention and resolution

Although the aim of the Guidance is to improve consistency between tax jurisdictions when applying the HTVI approach, attention also is drawn to other tools such as the conclusion of bilateral or multilateral advance pricing arrangements (APA). In short, an APA is an arrangement between the taxpayers and the tax authorities concerned that determines in advance of the transaction a set of criteria (such as methodology, comparability and adjustments, and critical assumptions with regard to future events) for the purpose of transfer pricing.

Should the application of the HTVI approach lead to double taxation, the Guidance stresses the importance of allowing access to the mutual agreement procedure (MAP) under applicable treaties. Such access should be granted without waiting until the adjustment under the HTVI approach has been effectively notified or charged.

The Guidance does not contain references to arbitration procedures.

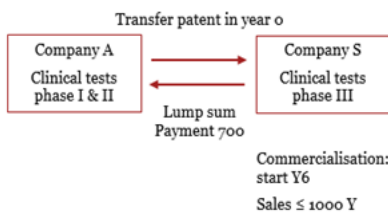
Examples

To illustrate the HTVI approach, the Guidance contains two examples. Although the examples are both set in the pharmaceutical industry, the examples should not be construed as limiting the application of the HTVI approach to the pharmaceutical industry. Both examples contain two scenarios.

The examples are based on assumptions that the intangibles in question qualify as HTVI and adjustments to the *ex ante* price setting based on *ex post* outcomes are appropriate.

Example 1

Initial facts



Scenario A: Phase III clinical tests were completed earlier than anticipated, allowing for commercialization in Year 3. Sales in Years 3 and 4 correspond to sales originally projected for Years 6 and 7. The taxpayer cannot demonstrate that the original pricing considered the early completion of clinical test and commercialization and that such development was unforeseeable.

The tax administration is auditing Years 0 through 2. On the basis of presumptive evidence, the tax administration adjusts the pricing of the patent transfer, which is based on the Net Present Value (NPV) of future cash flows, and makes adjustments to the taxable base.

Scenario B: Scenario B uses the same facts as Scenario A, but with a lower computed NPV. In this case, the safe-harbour threshold of 20% is not met, ruling out later adjustments.

Example 2

The initial facts are identical to those in Example 1. In Year 7, the tax administration receives information upon audit of the Year 3 to Year 5 that the actual sales in Year 5 and Year 6 were substantially higher than projected. The taxpayer does not demonstrate that it was unforeseeable that sales would reach the substantially higher levels.

On the basis of these facts, the tax administration uses presumptive evidence and may adjust the pricing of the transaction in Year 0. However, according to the draft guidance, alternative pricing adjustments may be available, such as an additional lump-sum payment in Year 3.

The discussion draft released 23 May 2017 contained a third example illustrating a case where no lump-sum payment was agreed upon and the arrangement was structured as a recurrent royalty payment. This example was removed from the Guidance.

The takeaway

BEPS Actions 8-10 introduced the principle of the HTVI approach. The Guidance that is now published aims at a common understanding and practice among tax authorities in applying the HTVI approach.

The changes compared to the discussion draft released in May 2017 are mostly of a cosmetic nature or add minor clarifications.

Note: The HTVI approach allows the re-characterization of transfers of intangibles using presumptions based upon alternative – even hypothetical – *ex post* pricing arrangements to determine *ex ante* value. In practice, this can lead to uncertainty and unpredictability, particularly for taxpayers. At the same time, it will open up avenues for disputes between taxpayers and tax authorities or between tax authorities when called upon to give relief under a corresponding transfer pricing adjustment.

This is in particular a concern as the Guidance does not delineate clear boundaries of what could be considered satisfactory evidence, nor does it clarify the subjective terminology and language used in the Guidance such as ‘unforeseeable’ or ‘extraordinary.’

Although the general guidance of Chapter I of the OECD TPG is applicable, it remains unclear whether the implementation guidance only addresses pricing arrangements or pricing structures, as was the intention of the HTVI discussion under the revised Chapter VI of the OECD TPG, or whether it allows for nonrecognition of the accurately delineated transactions.

Multinationals should be prepared to revisit intangible structures and adapt them where necessary assorted with documentation as this may assist avoiding the presumptive evidence approach.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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