Dr. Andrew Hickman
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By email

SUBJECT: DISCUSSION DRAFT ON HARD-TO-VALUE INTANGIBLES

18 June 2015

Dear Dr. Hickman,

By means of this letter, EY would like to share its comments on the public 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" (the Discussion Draft) as released by the OECD on 4 June 2015. We appreciate the opportunity to provide comments and to contribute to the public consultation and discussions about the transfer pricing aspects of hard-to-value intangibles (HTVIs). This letter presents the collective view of EY's global international tax network.

Key comments

Our key comments with respect to the Discussion Draft, as further elaborated upon in the "detailed comments" section of this letter, can be summarized as follows:

- We welcome the acknowledgement that unrelated parties do agree on payment for HTVIs based on projections, that these projections are inherently uncertain and that an outcome that does not align with the projections does not mean that the valuation or pricing of the HTVI is inappropriate.
- Overall, we believe that the approach as described in the Discussion Draft provides a fairly balanced approach with respect to the treatment of HTVIs. However, we also have a number of concerns regarding the Discussion Draft:
    - The mere fact that a transaction or arrangement between related parties may not be seen in the same form between independent parties does not mean that it should not be recognized as structured. More specifically, 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.
    - If taxpayers can provide evidence that due diligence is exercised in the financial forecast and price-setting process, the analysis should be respected. 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.

- Introduction of the suggested approach effectively would lead to the application of contingent pricing arrangements in a wide number of cases, by the tax authority of either the country of the buyer or the country of the seller, depending on the outcome. This would lead to an enormous burden for global businesses and to a significant amount of double taxation in many cases in which no element of base erosion and profit shifting can be found.
- In many countries, particularly developing countries, there is no framework for tax authorities to confirm the arm's length character of the transaction upfront (e.g., by means of an advance pricing arrangement), or obtaining certainty in advance is difficult and time-consuming. Introduction of de facto hindsight would create significant uncertainties for taxpayers which they could not avoid other than by including contingent payment arrangements in their transactions themselves.

- If the OECD nevertheless were to decide to introduce guidance as currently included in the Discussion Draft, we recommend adding additional objective elements to the definition of HTVI and more detail on the information that a taxpayer would be expected to provide (e.g., regarding the type of information and level of detail that would be required from taxpayers with respect to their projections). We would also strongly recommend the introduction of additional and more effective dispute resolution mechanisms, such as binding arbitration, at the same time.

More detailed comments with respect to the Discussion Draft are presented below. If you have any comments or questions, please feel free to contact any of the following:

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Yours Sincerely,
On behalf of EY

John Hobster / Ronald van den Brekel

Detailed comments

Our detailed comments with respect to the Discussion Draft are presented below, following the structure of the Discussion Draft in terms of sections and headers.

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

The Discussion Draft states that the question of how arm's length pricing should be determined when valuation of an intangible or rights in an intangible at the time of the transaction is highly uncertain should be resolved by reference to what independent enterprises would have done in comparable circumstances. The reference to independent party behavior implies that a taxpayer's decision on how to deal with the uncertainty (which may be to assume the risk) should be "replaced" with the decision that independent parties would have made. This would mean a re-characterization which, as per existing and proposed guidance in this regard, should only be allowed in specific circumstances. As indicated in the discussion draft on Actions 8, 9 and 10 issued on 19 December 2014, the mere fact that the transaction may not be seen between independent parties does not mean that it should not be recognized. Accordingly, the mere fact that independent enterprises may have included a contingent pricing clause in itself does not mean that related parties should be obliged to do so. If it is possible to price the transaction, tax authorities should refrain from deviating from the transaction "as structured" and the contractual terms agreed upon.

Hard-to-value intangibles

Special measures, such as those described in section D.3.1, should in our view only be adopted for those rare situations in which the arm's length principle and the existing guidance on the matter fail. However, as crafted, the proposed special measure would apply in many cases in which no element of base erosion and profit shifting can be found.

The special measure suggested for HTVIs is envisaged to apply to transactions involving intangibles as defined in paragraph 9 and 10. While we appreciate that there are challenges (from a transfer pricing perspective) with respect to intangibles for which the value is uncertain at the time of the transaction, we believe that many intangibles will fall within the definition, depending on how tax authorities will deal with highly subjective elements such as "sufficiently reliable comparables" and "reliable projections" and "highly uncertain." In particular in non-BEPS cases (which are likely to be the vast majority of the transactions involving HTVIs), taxpayers should be protected against the use of such subjective arguments by tax authorities and the uncertainty that comes with such use.

If the OECD nevertheless were to decide to introduce such guidance, we would recommend adding additional objective elements to the definition of HTVIs. We would also strongly recommend the introduction of additional and more effective dispute resolution mechanisms, such as binding arbitration, at the same time.

"The approach"

We fundamentally disagree that the ex post outcomes have any bearing on, or even provide any insight into, the arm's length nature of an arrangement at the time of the transaction. The Discussion Draft basically states that if the actual outcomes correspond with the expected outcomes, the projections were reliable. This is simply incorrect. The paragraphs as currently worded invite the use of hindsight disguised as a finding that the tax authority has not been able to confirm the reliability of the projection used. For the categories of intangibles identified in the Discussion Draft, there would be, almost by definition, a significant divergence, which under the

proposal would allow tax authorities to apply a contingent pricing arrangement by reference to the suggested approach. It seems fair to say that some tax authorities could be tempted to apply this in situations that are favorable to them. As such, this would lead to a situation of "systematic mispricing" similar to what the Discussion Draft is trying to tackle, except that this systematic mispricing would be after the fact and by the tax authorities. Furthermore, depending on the actual results (compared to the projections), either the tax authority of the buyer or the tax authority of the seller would apply an adjustment.

We propose that paragraphs 11 and 12 be reworded to state that unless the tax authority is able to demonstrate that the assumptions or projections did not take into account important foreseeable developments and events which has resulted in a significant difference between the projections and the ex post outcome, the projections should be respected.

We believe the second condition in paragraph 14 (i.e., that a taxpayer should be required to prove that any significant difference between the financial projections and actual outcomes is due to unforeseeable or extraordinary developments or events) should not be imposed on taxpayers. The example in paragraph 15 oversimplifies the potential for parties to satisfy this second condition. Suppose for example that one party sells a partially developed active ingredient to a related party and that the price is determined based on a number of scenarios, reasonably taking into consideration the information available at the time of the transaction. For simplicity, let's assume two scenarios, one of failure of the product and one of success. The probabilities of success and failure are estimated based on past projects and industry experience. Unfortunately (for the buyer), the product fails and therefore the income from the intangible transferred is significantly below the (probability-weighted expected) projections. The fact that there was a possibility of failure was perfectly foreseeable. We believe that if the forecast was made on a sound basis, the tax authority in the buyer-country should not be allowed to adjust the price of the transaction. Similarly, in case of success, the tax authority in the country of the seller also should not be allowed to do so.

Although the introduction in section D.3 indicates that there are a variety of steps that independent enterprises might undertake to deal with high uncertainty in valuation when pricing a transaction, including pricing based on projections of anticipated benefits, this could be interpreted as an indication that independent parties would apply contingent payment arrangements. This does not align with our understanding of independent party arrangements where there truly is a variety of approaches taken. In addition, if the tax authority is able to demonstrate that the assumptions or projections did not take into account important foreseeable developments, this should not by itself allow the tax authority to apply a contingent payment arrangement. At first instance, the tax authority should adjust the price based on the inclusion of the foreseeable developments. Only in exceptional cases, in which such pricing would not be possible, should the tax authority be allowed to reconstruct the transaction, such as changing its economic substance including through the replacement of the existing pricing clause with a contingent payment clause.

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