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Global Tax Alert

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

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Executive summary

On 21 June 2018, the Organisation for Economic Co-operation and Development (OECD) released final guidance for tax administrations on the application of the approach to hard-to-value intangibles (the Final Guidance). The Final Guidance has been incorporated into the OECD Transfer Pricing Guidelines (OECD TPG), as an annex to Chapter VI.

The hard-to-value-intangibles (HTVI) approach is stipulated in the final report on transfer pricing under Base Erosion and Profit Shifting (BEPS) Actions 8-10 (Actions 8-10 Report) and has been formally incorporated into the OECD TPG.[1] The Final Guidance aims at reaching a common understanding and practice among tax administrations on how to apply adjustments resulting from the application of the HTVI approach, and is intended to improve consistency and reduce the risk of economic double taxation.

The Final Guidance contains three sections including:

- Introduction of the principles that should underlie the application of the HTVI approach by tax administrations
- Two examples to clarify the application of the HTVI approach in different scenarios
- Clarification on the interaction between the HTVI approach and dispute prevention and resolution

Building a better working world

The Final Guidance does not significantly differ from the last discussion draft on the implementation guidance on HTVI released by the OECD on 23 May 2017[2] (the Discussion Draft) for public comments. As compared to the Discussion Draft, the Final Guidance now emphasizes, among others, that the guidance contained in Chapters I-III, and in particular chapter VI (on intangibles) and chapter VIII (on cost contribution arrangements) of the OECD TPG should be considered by tax administrations when evaluating *ex ante* pricing arrangements based on *ex post* outcomes. Under such circumstances, the Final Guidance stresses that appropriate risk-adjusted possibilities be accounted for with respect to situations that may have been known at the time of the transaction. Finally, it includes a more detailed discussion on the interaction of the HTVI approach with dispute prevention and resolution in accordance with the output contained in the final report on Action 14 of the BEPS project.[3]

The Final Guidance now represents a consensus view of the OECD's Committee on Fiscal Affairs and was approved by the Inclusive Framework on BEPS[4] on 4 June 2018.

Detailed discussion

Principles that should underlie the application of the HVTI approach by tax administrations

The treatment of HTVI for transfer pricing purposes is addressed in section D.4 of the Actions 8-10 Report.[5] The Final Guidance has been developed to tackle the asymmetry of information available between taxpayers and tax administrations regarding the potential value of an HTVI, when it is transferred. In summary, the HTVI approach authorizes tax administrations to use ex post evidence on the financial outcomes of an HTVI transaction (i.e., information gathered in hindsight about how valuable an intangible has turned out to be) as presumptive evidence on the appropriateness of the ex ante pricing arrangements. The BEPS Actions 8-10 Report also describes certain circumstances or exemptions where the HTVI approach may not be used. The ex post outcomes provide information on the determination of the valuation at the time of the transaction, but a potential revised valuation should not be based on actual income or cash flow without also taking into account risk-adjusted possibilities of such actual income or cash flow materializing, at the time of the transfer of the HTVI.

The Final Guidance also discusses the impact of timing issues for tax administrations applying the HTVI approach. In this respect, tax administrations are encouraged to apply audit practices to identify and act upon HTVI transactions as early as possible. However, inherent to this approach, it is recognized that *ex post* outcomes relevant for the pricing of the transfer of the HTVI may not be available shortly after the transaction. The Final Guidance also recognizes that the elapsed time between the transaction and the moment the ex post outcomes become available to tax administrations may not always correspond with the audit cycles or administrative and statutory time periods, in particular for intangibles that may not be exploited commercially until years after the transaction.

The Final Guidance states that the application of the HTVI approach should not be used to delay or bypass normal audit procedures. Some tax administrations may encounter difficulties in implementing the HTVI approach due to, for example, short audit cycles or a short statute of limitations. Such tax administrations may consider targeted changes to procedures or legislation to counter these application difficulties, such as the introduction of a requirement for taxpayers to promptly notify the tax administration when an intangible falling within the HTVI definition has been transferred, or an amendment of the normal statute of limitations.

The Final Guidance reiterates that adjustments by tax administrations may include an adjustment to the pricing structure adopted by the taxpayer, but should reflect one which would have been made by independent enterprises in comparable circumstances to take account of the valuation uncertainty in the pricing of the transaction.

Examples

The examples included in the Final Guidance illustrate the practical application of a transfer pricing adjustment arising from the application of the HTVI approach. Scenario A of Example 1 describes a case in which a taxpayer cannot demonstrate that it properly took into account certain possibilities that could have materialized, and that the taxpayer could not demonstrate that such a development was unforeseeable. As a result, the tax administration may use the presumptive evidence provided by the ex post outcomes to determine that this possibility was not taken into account when determining the valuation at the time

the HTVI was transferred. The original valuation is revised accordingly to include the appropriately risk-adjusted possibility of the circumstances, and the tax administration is entitled to make a transfer pricing adjustment for the difference in value. Scenario B of Example 1 describes the same facts and circumstances, however illustrates a situation in which the third exemption[6] listed in paragraph 6.193 of the OECD TPG is applicable, and as a result, the HTVI approach is not applicable.

In Example 2, similar to Example 1 scenario A, the application of the HTVI approach results in the tax administration being entitled to make an adjustment. In this example, the significant adjustment to the initial lump-sum payment for the transfer of the HTVI demonstrates the risks posed by the high uncertainty and therefore tax administrations may consider whether an alternative payment structure (e.g., a combination of an initial lump sum payment and additional contingent payments based on key milestones) might be more appropriate. The alternative payment structure may be (more) consistent with the fact that specific developments are not sufficiently predictable. The alternative payment structure should be consistent with what unrelated parties would have agreed to in comparable circumstances. The example notes that it is not intended to, and does not, imply that modification of the payment form can only occur when there is a common practice in the relevant business sector regarding the form of payment for the transfer of a particular type of intangible.

HTVI and the mutual agreement procedure

The Final Guidance incorporates several elements regarding dispute resolution from the final report on BEPS Action 14. Specifically, the Final Guidance prevents the application of the HTVI approach when the transfer of the HTVI is covered by a bilateral or multilateral advance pricing agreement in effect for the period in question between the jurisdictions of the transferee and the transferor.

In the event that the application of the HTVI leads to double taxation, it is important to permit resolution of such cases through access to the mutual agreement procedure (MAP) under an applicable treaty. The Final Guidance emphasizes that it is especially relevant for taxpayers to be able to set in motion a MAP procedure without waiting until the event of double taxation, but that they can set in motion a MAP procedure if it can be established that the actions of a tax administration probably will result in double taxation.

The Final Guidance also refers to a best practice in the BEPS Action 14 Report, for countries to implement appropriate procedures to permit taxpayer requests for multiyear resolution through the MAP of recurring issues with respect to filed tax years, where the relevant facts and circumstances are the same and subject to the verification of such facts and circumstance on audit.

Implications

The Final Guidance provides tax administrations with practical guidance for the application of the approach to HTVI, and is intended to improve consistency and reduce the risk of economic double taxation. Multinational businesses involved in the transfer of intangibles that might be considered HTVI should take the Final Guidance in consideration. Furthermore, multinational businesses that are facing (potential) double taxation as a result of adjustments related to HTVI should consider the use of MAP to relieve the double taxation.

Endnotes

1. See EY Global Tax Alert, *OECD releases final reports on BEPS Action Plan*, dated 6 October 2015.
2. See EY Global Tax Alert, OECD releases implementation guidance on hard-to-value intangibles, dated 23 May 2017.
3. See EY Global Tax Alert, *OECD releases final report on improving the effectiveness of dispute resolution mechanisms under Action 14*, dated 8 October 2015.
4. See EY Global Tax Alert, *OECD releases plan to establish inclusive framework for BEPS implementation*, dated 24 February 2016.
5. For a more detailed summary of the HTVI approach, see EY Global Tax Alert, *OECD issues final guidance on transfer pricing for intangibles under BEPS Action 8*, dated 13 October 2015.
6. This provides for an exemption to the HTVI approach if the adjustment to the compensation determined using *ex post* outcomes is within 20% of the compensation determined at the time of the transaction.

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