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Comments on the Public Discussion Draft on BEPS Action 8: Implementation Guidance on Hard-to-Value Intangibles

Dear Sirs,

First of all we would like to thank you for the exceptional work and results developed in the subject of transfer pricing within the BEPS project and for the opportunity to submit our comments on the Public Discussion Draft on BEPS "Action 8: Implementation Guidance on Hard-to-Value Intangibles" released on 23 May 2017 ("**Discussion Draft**").

While we acknowledge that the main goal of the Discussion Draft is to present a number of examples aimed at illustrating the practical implementation of the approach suggested by the OECD in Action 8-10 with reference to Hard-to-Value Intangibles[1] ("**HTVI**"), we believe that such document, aside to setting out the scope of application of the HTVI approach, should also lay down clear boundaries to the discretionality of

[1] OECD, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10: 2015 Final Reports*, OECD/G20 Base Erosion and Profit Shifting Project (Paris: OECD Publishing, 2015), pp. 110-112.

tax administrations in order to avoid that an excessive use of the HTVI approach could be detrimental to the certainty of transactions.

1. Burden of Proof

In all examples, the Discussion Draft assumes that the taxpayer cannot demonstrate that *(i)* its original valuation "*properly took into account*" certain possible developments or events and *(ii)* such developments or events were unforeseeable (paragraphs 19 and 24 of the Discussion Draft). In this respect it would be extremely useful that the Discussion Draft could also provide guidance for tax administrations (and therefore also for taxpayers) on the perimeter of the burden of proof that is placed on taxpayers.

More in detail, it should be clarified which is the minimum set of information that taxpayers should be required to prepare in order to meet the burden of proof. For instance, it should be clarified if, and to what extent, the information provided within the framework of transfer pricing documentation (Master file and Local file) set forth by BEPS Action 13[2] is considered to be sufficient.

Moreover, the examples do not provide any recommendations to tax administrations on how to distinguish between taxpayers' analyses that "*properly took into account*" possible developments/events and taxpayers' analyses that did not. In our opinion, this could create an unbalanced distribution of the burden of proof between taxpayers and tax administrations. Indeed, while on the one hand tax administrations should encounter few difficulties in challenging the appropriateness of an analysis based on an *ex post* review – also considering the several factors that have to be taken into account in performing such analysis – on the other hand taxpayers might be required to provide an evidence that is far from being straightforward (namely the proof that, at the time of performing the valuation, the evolutions had been properly taken into account or were unforeseeable).

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[2] OECD, *Transfer Pricing Documentation and Country-by-Country Reporting, Action 13: 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (Paris: OECD Publishing, 2015).

In our opinion, it should be clarified in the Discussion Draft that the burden of proof is considered to be satisfied by the taxpayer (*i.e.* the evolutions have been "*properly taken into account*") when, within the context of the above mentioned transfer pricing documentation or in a separate analysis, the evaluation of the possible scenarios contemplated also the evolutions that actually took place with a reasoned clarification of why such scenarios were considered as unlikely or with a low probability.

2. Re-Assessment of the Pricing Arrangements

The Discussion Draft contains examples of cases where in an audit conducted some years after a transfer of an HTVI the tax administration might argue that the price applied to the HTVI should have been different and therefore raises an adjustment. For instance, Example 2 of the Discussion Draft (paragraphs 24-29) assumes that during Year 7 the tax administration audits Company A for Years 3-5 and finds out that in Years 5 and 6 the sales of the product to which the HTVI relates were significantly higher than those anticipated. In accordance with the circumstances and the facts of the example, the tax administration might be entitled to make an adjustment to assess additional profits for the seller through either *(i)* a re-assessment of the price paid in Year 0 or *(ii)* a modification of the payment structure. In particular, Example 2 indicates that the latter could consist, based on the common practice in the relevant business sector, in an additional contingent payment triggered by the realization of a particular event (*i.e.* the earlier obtaining of the first market approval).

Here, the Discussion Draft seems to give tax administrations a wide discretion to freely adjust not only the price of the HTVI but also the (contractual) structure of intercompany pricing arrangements. In our opinion, the Discussion Draft should clarify that tax administrations should determine whether the prices applied in the controlled transactions satisfy the arm's length principle but should limit their interference on the taxpayers' flexibility in setting pricing arrangements to the exceptional circumstances where a transaction meets the conditions to be recharacterized[3].

Moreover, the discretion apparently attributed to tax administrations would have the effect of letting them arbitrarily choose a modification of the payment structure when a re-assessment of the original price is no longer possible because the tax year in which the transaction took place is barred by the statute of limitations. Indeed, in the mentioned example, the tax administration, by carrying out an audit in Year 7, would not be able in most countries to directly re-assess the price paid in Year 0 due to the applicable statute of limitations. A modification of the payment structure could therefore represent for tax administrations a specious way to make transfer pricing assessments even for years that are no longer open for assessment (regardless of the common practice on the structure of pricing arrangements in the relevant business sector). In our opinion, this approach would be in contrast with the same purposes of the rules governing the statute of limitations (which are aimed at granting certainty in all tax relationships) and should be discouraged.

3. Need to Factor in the Impact of the Subsequent Behavior of the Purchaser

The Discussion Draft apparently does not take into account the effects of the subsequent behavior of the purchaser. Indeed, the actions undertaken by the purchaser after the acquisition of the HTVI may have a strong impact on the development of the intangible and on the revenues (or the timing thereof) derived from the subsequent exploitation. For example, the purchaser might increase or accelerate its investment efforts in research activities due to factors that are not under the sphere of influence of the seller (e.g. a change in strategy of the purchaser following the failure of another research program). Therefore, it should be explicitly confirmed

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[3] See paragraph 16 of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (approved by the OECD on 22 July 2010), which provides that "*Tax administrations are encouraged to take into account the taxpayer's commercial judgement about the application of the arm's length principle in their examination practices and to undertake their analyses of transfer pricing from that perspective*".

that the above circumstances, which might well lead to a deviation from the original business plan, would hardly be foreseeable at the time of the valuation and, in any case, would not be taken into account in transactions concluded between third parties.

4. Recognition of Downward Adjustments

The Discussion Draft only provides examples where *ex post* outcomes are used by tax administrations of the State of the seller in order to carry out upward adjustments. However, considering the complexity and uncertainty of HTVI valuations, both upward and downward adjustments should be considered by tax administrations. We therefore suggest to provide additional examples regarding the use of *ex post* outcomes in order to assess a downward adjustment and to encourage OECD member countries to enact downward adjustments rules in their domestic legislation in case of HTVI transactions.

5. Reiterated Tax Audits of the Same HTVI Transaction

As a final remark, we highlight that the examples provided by the Discussion Draft seem to allow tax administrations to recurrently carry out audits on the same HTVI transaction on the basis of *ex post* outcomes progressively arising year by year. For example, under the facts described in paragraphs 17-18 of the Discussion Draft, the tax administration might initially adjust the price of the HTVI based on an audit carried out in Year 3 and, subsequently, adjust the overall pricing structure of the same HTVI transaction requiring a lump sum payment in Year 4 based on further *ex post* outcomes arising during an audit in Year 5 (which were not available during the previous audit). This creates a distortion that is contrary to the rationale of the HTVI approach and would expose taxpayers to the risk of an open-ended uncertainty on these transactions.

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Please feel free to contact us at TP@maisto.it with any questions or comments concerning this letter.

Sincerely yours,

Maisto e Associati