The **BEPS** Monitoring Group

COMMENTS ON

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

These comments have been prepared by the BEPS Monitoring Group (BMG). The BMG is a network of experts on various aspects of international tax, set up by a number of civil society organizations which research and campaign for tax justice including the Global Alliance for Tax Justice, Red de Justicia Fiscal de America Latina y el Caribe, Tax Justice Network, Christian Aid, Action Aid, Oxfam, and Tax Research UK. These comments have not been approved in advance by these organizations, which do not necessarily accept every detail or specific point made here, but they support the work of the BMG and endorse its general perspectives. They have been drafted by Jeffery Kadet, with comments from Tommaso Faccio and Sol Picciotto.

We are grateful for the opportunity to submit comments on this public discussion draft "BEPS Action 8 - Implementation Guidance on Hard-to-Value Intangibles".

GENERAL REMARKS

The Approach Adopted

The transfer of intangible property rights to related entities is one of the main techniques used by multinational enterprises (MNEs) to avoid taxes through base erosion and profit shifting (BEPS). Such assets are especially hard to value if they are transferred at an early stage, since their income-generating potential will be speculative, although best known to the firm itself. The three examples in the discussion draft all involve a transfer of such rights that have been only *partially developed*. Specifically, the examples involve a patented pharmaceutical compound that is partially through its clinical trials.

In the absence of acute economic duress or some very significant and identifiable business reason (e.g. for risk sharing, or if the transferee has a significant distribution network not possessed by the transferor), an entity (such as Company A in the examples) developing intangible rights within its core business would virtually never transfer all or any portion of those rights to unrelated persons. These are most typically core products that would be considered "crown jewels". The lack of real third-party transfers of such rights is one of the reasons why the "no reliable comparables" condition of paragraph 6.189 will virtually always be met.

While MNEs are very resourceful and creative in providing important business reasons for their tax structuring, the reality virtually always is that the sort of transfer included in the three examples has no purpose other than BEPS. Further, there are seldom any substantive operational changes that accompany such transfers.

Hence, this discussion draft (DD) rightly assumes the sad reality of "information asymmetry" and its negative effects. It provides clear and simply-stated guidance that allows taxpayers and tax authorities to identify matters requiring additional research and thinking. An example of this is the suggestion in paragraph 27 that tax authorities should consider, when appropriate, possible alternative payment structures.

We have set out below in the Specific Comments section a number of suggested additions that would be useful to both tax administrators and taxpayers alike, but which would allow retention of the discussion draft's concise and easy-to-understand approach.

Avoiding "Legitimising" BEPS Structures

As noted above, the examples involve a transfer of intangible rights that have only been *partially developed*. It was also stated that entities developing intangible rights within their core business such as that in the three examples would virtually never transfer all or any portion of those rights to unrelated persons. Without question, the examples involve a BEPS-motivated transfer, but the examples describe it as if it were any other intercompany business transaction.

Our concern is that this approach effectively legitimises, in the mind of the reader, BEPS motivated structuring.

Admittedly, our worldwide legal and tax system provides MNEs with full entity and contractual freedom, allowing MNEs to create at their discretion new legal entities, transfer assets, and enter into any intercompany transactions which they so desire. While our system allows this, guidance such as this discussion draft should not be describing BEPS planning in any manner that legitimises it.

In order to avoid legitimising such planning, we suggest adding a statement at the end of paragraph 17 such as the following, which would be included as a parenthetical:

> Since such a transfer of partially developed rights to a drug is a transaction not likely to be found between unrelated parties in the absence of acute economic duress or some very significant and identifiable business reason, it invites close tax authority scrutiny.

SPECIFIC COMMENTS

Dealing with the 20% "Safe Harbour"

In Example 1 Scenario B, the taxpayer failed to properly take into account the reason for differences between financial projections and actual outcomes. Because of the percentage amount of this difference (under 20%), the exemption provided by Exemption (iii) in paragraph 6.193 ensures that the HTVI approach does not apply (though an adjustment under other sections of the Guidelines may be appropriate).

Knowing the manner in which many MNEs "craft" their structuring and transfer pricing to meet what are effectively "safe harbours", which can be in percentage or absolute terms, we believe that the use of the 20% factor in paragraph 6.193 merely incentives tax-motivated transfers of intangibles that considered this 20% when setting the price at the time of the transfer. We understand that this HTVI discussion draft is not asking for recommendations regarding settled language in the Guidelines. Recognizing this, we suggest that the following change be made in Example 1 Scenario B. We recommend that the second paragraph of Scenario B read as follows:

> 23. In accordance with the approach to HTVI, the tax administration is entitled to make an adjustment to assess the additional profits of 100 in Year 0. Note that item (iii) of paragraph 6.193 may apply in any case where the adjustment to the compensation for the transfer is within 20% of the compensation determined at the time of the transaction. In this example, in the absence of evidence that the taxpayer set its pricing taking into account this 20% factor, the exemption provided by item (iii) applies since the adjustment to the compensation for the transfer is within 20% of the compensation determined at the time of the transaction. Notwithstanding that the HTVI approach does not apply, an adjustment under other sections of these Guidelines may be appropriate.

Similarly, the following should be added at the end of Example 3 (paragraph 30):

> A tax authority may determine that Exemption (iii) in paragraph 6.193 would not apply if there is evidence that the taxpayer set its royalty rate taking into account this 20% factor.

Guidance Concerning Transaction Characterisation

Following on from these points, the discussion of the examples should add guidance that the conduct of the related parties must be considered in light of the transfer of intangible property. The contractual form need not be simply accepted at face value.

For example, the facts of the example (paragraph 17) state that Company S will be responsible for the Phase III trials following the transfer. However, this begs the questions: are the personnel responsible for the product's development and its testing up to the point of transfer (presumably Company A's employees or its independent contractors) still in charge? Or, has there been a full and complete hand-off to an already existing, independent, and discrete Company S management that is capable of managing the relevant risks?

The reality is that in related party situations where the primary focus is BEPS planning, there will virtually never be any full and complete hand-off.

Guidance should be provided that directs taxpayers and tax authorities to section D.2. of Chapter I of the Transfer Pricing Guidelines.

Guidance Concerning Capacity of Transferee

Although these three examples do not involve cost contribution arrangements, the discussion draft would provide some particularly useful guidance by referencing some of the concepts covered in some detail in Chapter VIII of the Transfer Pricing Guidelines. In particular, section C.2. (paragraphs 8.14 – 8.18) makes clear that a group member can only be a participant in a CCA if it in fact benefits from the objectives of the CCA activity. This is in contrast to only benefiting from performing the function, which in the discussion draft's examples is the Phase III clinical trials. Further, the group member cannot be a participant if it does not exercise control over the specific risks it assumes under the CCA and does not have the financial capacity to assume these risks.

Since these concepts so well articulated in respect of CCAs (and which arise from the principles covered in Chapter I) apply equally to intercompany transfers of intangible rights, the guidance should refer to section C.2. of Chapter VIII. If the transferee of the intangible rights would not be qualified to be a participant in a CCA with the transferor, then it would equally not be qualified to be treated as the owner of those rights.

Additional Analytical Tools

This discussion draft clearly acknowledges, but fails to adequately address, the endemic and serious problem of information asymmetry between a tax authority and a company. We have previously recommended that this issue could be addressed through a reversal of the burden of proof, with a presumption that any intra-firm transfer of HTVIs should be subject to pricing based on subsequent consideration of the actual income produced, unless the taxpayer can show that specified criteria were satisfied. We also proposed two additional criteria for such a showing: proof that the transfer did not result in a significantly lower effective tax rate, and a 'purpose test' requiring satisfactory evidence of the legal and commercial reasons for the transfer. Such a clearly stated reversal of the burden of proof would create a much stronger incentive for firms to cease tax-motivated transfers of intangibles.

Although the October 5, 2015, Final Report for Actions 8-10 did not include this specific suggestion, we recommend that as additional guidance for taxpayers and tax authorities, the examples suggest these two tools to help in the evaluation process:

- An objective analysis determining whether the transfer resulted in a significantly lower effective tax rate for the MNE as a whole, and
- A 'purpose test' critically analyzing the stated legal and commercial reasons for the transfer.

Guidance Concerning the Profit Split Method

Work on the profit split method is, at this time, still ongoing. Irrespective of the outcome of that work, it should be recognized that this sort of intangible property transfer will often be a strong candidate for application of the profit split method. Hence, the examples should simply note the fact, perhaps in paragraph 27, that the profit split method is an additional approach that should be considered in determining how to deal with the risks posed by the high uncertainty in valuing the intangible property.

Case Study Addendum

We suggest that consideration be given to adding a training addendum that could provide more detail for both the matters already referred to in the examples as well as to the various additional items that we have included in this letter. Using an addendum would retain the concise nature of the discussion draft while providing more detail for those desiring it.