BEPS MONITORING GROUP

Discussion Draft for BEPS Action 8: Hard-to-Value Intangibles

This response is submitted 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. This paper has 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.

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We welcome this opportunity to comment on this Discussion Draft (DD), and to participate in the public consultation.

SUMMARY

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. This discussion draft (DD) proposes that, in specific circumstances, the price of the asset transfer can be adjusted subsequently by tax authorities, taking into account the income actually generated. However, the DD specifies a number of conditions which must apply for this approach to be adopted.

Although desirable, in our view the proposals do not go far enough in two respects. First, the mechanism adopted should itself discourage transfers taking advantage of ex ante pricing, which is where most BEPS concerns and risk arise. Second, the DD must aim to reduce the endemic and serious problem of information asymmetry between a tax authority and a company. This is rooted in the requirement under the arm's length principle to evaluate internal transfers within a firm, since the tax authority can never know a firm's business better than the firm does.

Hence, we suggest instead 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 propose 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. This reversal of the burden of proof will create a much stronger incentive for firms to cease tax-motivated transfers of intangibles. In addition, to provide more certainty, we suggest an APA-like ruling process.

GENERAL COMMENTS

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). The initial development of such intangible assets usually requires large upfront investments which are essentially sunk costs, although they can usually be treated as tax deductible. If such assets can be transferred to an affiliate holding company formed in a suitable jurisdiction, their use can be licensed to operating company affiliates in foreign

countries, resulting in tax-deductible royalty payments. This income can be routed through another affiliate, acting as a conduit to reduce or eliminate withholding taxes in the source country, resulting in totally tax-free earnings accumulated in the cash-box asset holding company.

Tax authorities have the power to challenge such profit-shifting, but under the separate entity principle they are expected to do so by requiring that the price paid on the initial transfer of such assets is comparable with the price that would have been paid by independent parties transacting at 'arm's length'. If the assets are transferred before they begin to generate significant profit, this price will necessarily be quite low, since the income-generating potential of the assets will be speculative. It is difficult for a tax authority to challenge a low valuation based on comparables, as it will know far less than the company about this potential value (asymmetric knowledge). Hence, these can be described as hard to value intangibles (HTVIs). [1]

Even more importantly, the MNE has nothing to lose by the transfer, since it is not a true sale to an independent entity which could be a potential competitor, but only a paper transfer to an affiliate within the group. MNEs today are generally centrally managed, controlled, and coordinated organizations that act as a unity. They are not independent and separate business units that all just happen to have some common ownership. Their explanations for making HTVI transfers from one entity to another are normally simply efforts to put a non-tax-motivated gloss on the relevant transfers. The typically stated motivation for the transfer, for example for the efficiencies of centralized management of IP, is mere window dressing.

For these reasons, in our view the application of the arm's length principle is inappropriate in these circumstances. To deal with this, the discussion draft (DD) proposes that, in specific circumstances, the price of the asset transfer can be adjusted subsequently (ex post), and can take into account the income actually generated. However, the DD specifies a number of conditions which must apply for this approach to be adopted, in particular (i) that independent enterprises would have included a price adjustment clause in the contract, or that the subsequent developments would have led them to renegotiate the terms (para. 5), and (ii) that the intangibles have characteristics that make them hard to value, such as those listed in DD para. 10. It also specifically excludes application of the approach if the company

> 1. provides full details of its ex ante projections used at the time of the transfer to determine the pricing arrangements, including how risks were accounted for in calculations to determine the price (e.g. probability-weighted), and the comprehensiveness of its consideration of reasonably foreseeable events and other risks, and
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> 2. provides satisfactory evidence that any significant difference between the financial projections and actual outcomes is due to unforeseeable or extraordinary developments or events occurring after the determination of the price that could not

[1] The only other practical approach that tax authorities have within this 'separate entity' principle is to attempt to re-characterise the form that the taxpayer has chosen. A recent example of this approach is the attempt by the U.S. Internal Revenue Service to reverse the benefits of certain BEPS structuring conducted by Caterpillar Inc. over the last 15 years. This effort by the IRS was disclosed in certain regulatory filings made by Caterpillar earlier this year. While 'practical', such re-characterisation efforts have typically been uncertain of success; they're almost a toss-up. Such disputes will often become the subject of litigation with court decisions sometimes sustaining the relevant tax authority and sometimes the taxpayer's position.

have been anticipated by the associated enterprises at the time of the transaction. (Para. 14).

We entirely agree that, if the aim is to establish an appropriate price for the transfer, this is the right and appropriate guidance. In our view, however, it is necessary to begin with different assumptions. Our honest perception is that many, if not the vast majority, of related party transfers of HTVIs either are motivated by BEPS objectives or, at a minimum, carry significant BEPS risks for the governments concerned. The approach adopted in the DD will make this a little more difficult for MNEs, by requiring them to produce documentation and analyses demonstrating calculations of projections and evaluations of risk. This will entail more work for their legions of advisers, who will no doubt earn substantial fees. The trouble and expense involved will very likely deter some, especially smaller MNEs from continuing with such structures. However, for the rules to be effective, tax authorities will also need to make substantial investments of time for skilled specialists to analyze and evaluate the documentation provided by companies, to substantiate a challenge. Even as well-resourced an authority as the United States Internal Revenue Service recently had to engage outside advisers at a reported cost of $2m to assist with an audit of Microsoft. It would be very hard for smaller tax authorities, especially in developing countries, to apply the resources necessary to make these rules effective.

Considering today's environment where the bulk of intra-group HTVI transfers, especially those conducted on an ex ante basis, will have BEPS motivation and/or risk, we suggest that any transfer within a MNE group on an ex ante pricing basis should be *presumed* to have potential BEPS consequences unless established otherwise. If not established otherwise, then an ex post commensurate with income concept would be applied to attribute appropriate levels of actual profit in the hands of the transferor and transferee.

The conditions stated in para. 14 cited above are of course very appropriate. However, under the approach we are suggesting, they are *not* conditions that *prevent* a tax authority's actions. Rather, they should be conditions to be satisfied by the taxpayer to override the presumption that any intra-group transfer of an HTVI should be measured solely on an ex post commensurate with income concept to place appropriate levels of future profit in the hands of the transferor and transferee.

This approach, in contrast to that suggested in the Discussion Draft, will *encourage* MNEs to adopt ex post pricing approaches for any transfers of HTVI that have truly been conducted for legitimate legal and commercial purposes. What is suggested in the Discussion Draft will only encourage more ex ante pricing with the high expectation of the MNEs that tax authorities will have little ability to understand and actually object to the complicated detailed description and evidence of differences.

SPECIFIC COMMENTS

1. Comments are invited on whether there are mechanisms that could be adopted to provide greater certainty for taxpayers regarding the application of the approach to HTVI.

We suggest adoption of a ruling procedure along the lines of those used for APAs to provide for bilateral approval of the formula or other mechanism that will be applied on an ex post basis to attribute an appropriate level of profit. This should operate in conjunction with the presumption, described in the previous section, that any related party transfer of a HTVI should be subject to ex post price adjustment, unless the taxpayer can justify the ex ante pricing.

2. Comments are invited on whether any additional exemptions should be added to the exemption contained in paragraph 14 of this Discussion Draft. Where additional exemptions are proposed, commentators should explain how the exemption should be framed, considering the aims of the approach set out in the Discussion Draft.

As indicated earlier, we have suggested that any transfer of an HTVI on an ex ante basis be presumed to have potential BEPS consequences unless established otherwise. If not established otherwise, then an ex post commensurate with income concept should apply to place an appropriate level of actual profit in the hands of the transferor.

If our suggested presumption approach is not adopted, then we suggest the following additional conditions that should be added to paragraph 14:

> 3. provides satisfactory evidence that the income recognized in the hands of the transferee (including any indirect transferee due to any further transfer, license, or other effective disposition of the HTVI or any portion of it) has been subjected to an effective tax rate that is no less than 95% of the rate at which the relevant income would have been taxed in the hands of the transferor had the transfer of the HTVI not taken place;
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> 4. provides satisfactory evidence of the legal and commercial reasons behind the business decision to make the HTVI transfer.

If our presumption approach is adopted, then these additional suggestions should be included as being helpful to any effort a taxpayer chooses to make to overcome the presumption.

3. Comments are invited on whether the notion of "significant difference" in paragraph 13 should be defined, and, if so, what mechanisms could be used to determine whether a difference between the ex ante financial projections and the ex post financial outcomes is significant.

We believe that 'significant' should be defined as the lesser of both a percentage difference and an absolute amount of difference. For example, it could be defined as the lesser of (i) 20% of the median financial projection and (ii) Euros 1 million. Larger developed countries might of course choose to place the absolute amount at Euros 10 million or some other number. For many countries in this world, the lower suggested amount is very material.

4. Comments are invited on what further matters would be useful to consider in any follow-up guidance on practical and consistent implementation of the approach.

Unfortunately, the discussion in this Discussion Draft is a painful reminder of how wide the chasm is between the knowledge, control and power of the average MNE and that of the average tax authority in dealing with a HTVI. The fact that, as mentioned above, even the heavily-resourced and highly sophisticated U.S. Internal Revenue Service is fighting with Microsoft about the IRS's hiring an outside consultant to help it with transfer pricing issues is testament to this. Tax authorities simply do not have the required internal knowledge or resources to understand a company's business as well as the company itself does. The efforts that Microsoft has been making to disqualify the consultant from participating in the audit demonstrates how much such firms value their superiority of technical resources. The requirement under the arm's length principle to evaluate internal transfers within a firm means that a tax administration will always be at a disadvantage attempting to apply it.

Clearly, for the reasonable administration of tax systems, the mechanics of the systems themselves must encourage taxpayers to act based on non-tax factors and not be encouraged to create BEPS structures. Creating as a mechanism a presumption, as we have suggested, that will discourage transfers on an ex ante basis, along with a ruling procedure for splitting

the ex post results, could significantly reduce BEPS-motivated HTVI transfers and reduce as well the need for taxpayers and tax authorities to review such transfers. Where there have been legitimate legal and commercial reasons for a transfer, then a taxpayer should spend relatively little effort to secure a ruling for the ex post split of the results.

This Discussion Draft is a powerful statement for the benefits of the expanded use of the profit split method. In prior comment letters, we have recommended that guidance be provided for specific concrete allocation keys for all common business models along with a clear statement of the principles involved so that allocation keys can be determined as new business models are developed. With such use of the profit split method, the intractable issues raised in this Discussion Draft could be completely sidestepped.