Organisation for Economic Cooperation and Development
Centre for Tax Policy and Administration
Attn. Jefferson VanderWolk, Head of the Tax Treaty, Transfer Pricing & Financial Transactions Division
2, Rue André Pascal
75775 Paris, France

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

Dear Mr. VanderWolk:

The National Foreign Trade Council (the "NFTC") is pleased to provide written comments on the Discussion Draft on BEPS Action 8: Implementation Guidance on Hard-to-Value Intangibles, published May 23, 2017 (the "Discussion Draft").

The NFTC, organized in 1914, is an association of some 250 U.S. business enterprises engaged in all aspects of international trade and investment. Our membership covers the full spectrum of industrial, commercial, financial, and service activities. Our members value the work of the OECD in establishing international tax and transfer pricing norms that promote consistency for enterprises conducting cross-border operations, and we appreciate the opportunity to comment on this important project. A list of the companies comprising the NFTC's Board of Directors is attached as an Appendix.

The NFTC appreciates the opportunity to provide comments to the OECD on these important issues. In general, because the NFTC believes the use of hindsight in evaluating ex ante transfer pricing arrangements may be considered inconsistent with the arm's length principle, it should be limited to narrowly circumscribed cases. We applaud the OECD for providing some guidance with regard to the implementation and administration of the approach for HTVI. We agree, consistent with paragraph 3 of the Discussion Draft, that the objectives of such guidance should be to improve consistency with regard to the approach for HTVI, and to reduce the risk of economic double taxation.

Pre-2015 Transfers of HTVI

Before commenting on the text of the Discussion Draft itself, we wish to reiterate our recommendation that the OECD clarify that the approach to HTVI be applied only in the case of transfers of intangibles that occur after 2015, the year in which the 2015 Final Report for Actions 8-10 was issued. The approach to HTVI introduced by the 2015 Final Report, in particular its use of hindsight to evaluate ex ante transfer pricing arrangements and its establishment of a new evidentiary standard, is an extraordinary special measure that was not contemplated by the Transfer Pricing Guidelines prior to that date. To ensure the approach operates as intended, it should be applied on a prospective basis only.

As noted in the Discussion Draft, the approach to HTVI permits tax administrations to consider ex post outcomes as presumptive evidence about the appropriateness of ex ante pricing arrangements. We agree with the Discussion Draft's clear guidance that tax administrations cannot use ex post outcomes as the basis to make an adjustment to the transaction, but rather must determine the appropriate ex ante pricing based on the information available at that time and the proper application of probability factors to expected outcomes to price the transfer. Equally important, taxpayers have the opportunity to rebut such presumptive evidence by demonstrating the reliability of the information supporting the pricing methodology adopted at the time of the transfer. This ability to rebut is critical to the operation of the approach to HTVI; without such ability, the approach would permit tax administrators to base adjustments to contemporaneous valuations on the actual profits or cash flows achieved many years later. The presumption of hindsight can be rebutted by evidence that other HTVI transfers by the taxpayer generated returns that underperformed the earlier forecast. It should be evidence of good faith valuations if the history of IP transfers average to the combined forecasts. Taxpayers should be able to use their own ex post discovery of contemporaneous facts unknown to the taxpayer at the time of pricing the transaction to support their rebuttal. Even before the rebuttal is required, taxpayers should be able to use ex post discovery of contemporaneous information, such as comparables unknown when the transaction was priced, to contest the tax administration's assertion that the transferred intangibles meet the definition HTVI.

For transfers after 2015, taxpayers are on notice with respect to the approach to HTVI. Taxpayers can ensure that valuations of HTVI are performed in a manner that takes into account the probability of a variety of outcomes, and they can document the manner in which such outcomes were considered. Alternatively, taxpayers can choose to provide for payment terms (e.g., contingent or milestone payments) that would automatically take into account actual outcomes. Such practices will better ensure appropriate results consistent with the principles of the BEPS exercise.

However, valuations of pre-2015 transactions could not have been performed in contemplation of the approach to HTVI because there was no sanctioned approach to HTVI prior to that date. A taxpayer may have no meaningful opportunity to rebut an adjustment to a pre-2015 transfer based on ex post outcomes because that taxpayer relied on valuations and documentation that were prepared in accordance with then-prevailing standards. It is unfair to apply new evidentiary standards to transactions completed prior to the adoption of such standards. For these reasons, we recommend that the OECD clarify that the approach to HTVI be applied only in the case of transfers of intangibles that occur after 2015. The OECD should also clarify that taxpayers can use contemporaneous information discovered ex post to both contest the determination that the transferred intangibles are within the scope of the HTVI rules and to rebut the presumption in favor of the tax administration's adjustment.

<u>Example 1 – Taking into Account and Reflecting the Possibility of Outcomes, Rather than Actual Outcomes</u>

In Example 1 of the Discussion Draft, Company A transfers in Year 0 the patent rights related to a pharmaceutical compound to an affiliate for a lump sum of 700. The transfer price was determined on the basis of expected cash flows from the exploitation of the developed drug once the drug was approved for use. The discount rate was determined with reference to external data analyzing the risk of failure for similar drugs at similar stages. The taxpayer assumed that sales would not exceed 1,000 a year, and that commercialization would not commence until Year 6. In fact, commercialization started in Year 3. The last sentence of Paragraph 19 explains that the taxpayer cannot rebut the presumptive evidence from the ex post outcome in part because the taxpayer "cannot demonstrate that its original valuation <u>properly</u> took into account the possibility that sales would arise in earlier periods." (Emphasis added).

The NFTC recommends that the word "properly" be omitted from the last sentence of Paragraph 19. Under the summary facts of Example 1, it appears that the original valuation did not take into account the possibility that commercialization could commence prior to Year 6. If that is the case, then the word "properly" should be omitted. If instead Example 1 is intended as an illustration of a case in which the original valuation took into account the possibility that sales would arise in prior periods, but did not do so appropriately (for example, by assigning too low a probability to that potential outcome based on the facts known at the time of the transfer), then additional language should be added to Example 1 to lay the requisite predicate for that conclusion.

The second sentence of paragraphs 20 and 22 illustrates the approach to HTVI by providing that the "taxpayer's original valuation is revised to include earlier sales". The NFTC recommends that these sentences be clarified to provide that the original valuation is revised to include the possibility of earlier sales. If the actually realized earlier sales, rather than the possibility of earlier sales, were taken into account, then the present value of the transfer rights would be based solely on the actual outcome, which is inconsistent with the approach to HTVI and the guidance in the Discussion Draft. See para. 6 of the Discussion Draft ("However, it would be incorrect to base the revised valuation on the actual income or cash flows without also taking into account the probability, at the time the transaction, of the income or cash flows being achieved.") This change would bring the language in line with what we believe to be the intended application of the approach to HTVI, as well as the parallel language of paragraph 25.

Example 2 – Taking into Account the Possibility of Outcomes, and Non-recognition of Actual Payment Form

The facts of Example 2 are the same as in Example 1, except that during an audit of the taxpayer for Years 3-5, the tax administration learns that sales in each of Years 4 and 5 were 1,500. The taxpayer had not projected sales any higher than 1,000 in any year. Like Paragraph 19, the last sentence of Paragraph 24 explains that the taxpayer cannot rebut the presumptive evidence from the ex post outcome in part because the taxpayer "cannot demonstrate that its original valuation properly took into account the possibility that sales would reach these levels." (Emphasis added).

Consistent with the recommended change to Paragraph 19, the NFTC recommends that the word "properly" be omitted from the last sentence of Paragraph 19. Under the summary facts of Example 2, it appears that the original valuation did not take into account the possibility that sales could be higher than 1,000. If that is the case, then the word "properly" should be omitted. If instead Example 2 is intended as an illustration of a case in which the original valuation took into account the possibility that sales could exceed 1,000, but did not do so appropriately (for example, by assigning too low a probability to that potential outcome based on the facts known at the time of the transfer), then additional language should be added to Example 2 to lay the requisite predicate for that conclusion. An estimate of sales in a valuation typically represents the most likely outcome, or a probability-weighted average of potential outcomes, based on the facts and circumstances available at the time. It typically reflects forecasts that the business uses for commercial purposes. A valuation based on the highest foreseeable level of sales would not be reliable unless the result was heavily discounted to reflect the high probability that such sales would not be achieved.

Paragraphs 27- 29 discuss the range of potential adjustments the tax administration may make under the HTVI approach. In particular, it provides two alternatives: (1) the tax administration may re-assess the lump sum paid in Year 0, or (2) the tax administration may impose an alternative payment structure in which additional contingent payments were due upon the successful completion of development phases, and impose an additional lump sum payment in Year 3. This second alternative may be considered whether or not there is a common practice in the relevant business sector to provide for such contingent payment arrangements.

The NFTC recommends that this second alternative be reconsidered. The form of payment can be a critical element to the terns of a transaction. See paras. 6.179 and 6.180 of the OECD Transfer Pricing Guidelines. Under the second alternative, the taxpayer's actual transaction (a transfer in exchange for a lump sum) is disregarded in favor of another, hypothetical transaction (a transfer in exchange for a lump sum and contingent payments) that is inconsistent with common practice in the relevant business sector. A tax administration may not disregard the actual transaction entered into by the taxpayer unless the exceptional circumstances of paragraphs 1.122 – 1.125 of the OECD Transfer Pricing Guidelines are met. Respect for actual transactions is critical because "non-recognition can be contentious and a source of double taxation." Paragraph 1.122. The key question in this analysis is whether the actual transaction possesses the commercial rationality of arrangements that would be agreed between unrelated parties under comparable circumstances. There is no suggestion in the Discussion Draft that this standard is met or is even being applied; indeed, paragraph 28 states that there is no intention to 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." The second alternative should either be eliminated or redrafted in light of the standard for disregarding actual transactions.

<u>Example 3 – Adjustments with respect to Closed Years and the Mutual Agreement Procedure</u>

The facts of Example 3 are similar to those in Example 1, except that the payment form is a periodic royalty based on a percentage of anticipated sales. The tax administration determines on an audit of Years 3-5 in Year 7 that the value of the transferred intangible was higher than that determined in the original valuation, and therefore that the royalty rate should have been higher in all years. Presumably in recognition of the fact that Years 0-2 may be closed to adjustment due to a local law statute of limitations, and the possibility that the tax administration may nevertheless attempt to make an adjustment with respect to royalties paid in closed years by imposing a "catch up" adjustment in open years, footnote 1 states the following:

> Countries may take different positions under their domestic rules relating to statutes of limitations as to whether primary and corresponding adjustments may be made during open tax years with respect to amounts that relate to closed tax years. Recognising these differences, countries should endeavor to reach agreement under the mutual agreement procedure in the relevant treaty to resolve cases of double taxation at least for open years under statute of limitation rules that would have applied if the country making the corresponding adjustment had itself made the primary adjustment. (Emphasis added.)

We appreciate that the OECD cannot dictate to countries how to structure or interpret domestic statutes of limitations. However, where a taxpayer has structured an arrangement to provide for the use of intangibles in exchange for a royalty paid each year based on sales in that year, it seems inappropriate to use the HTVI approach to permit adjustments to royalties paid in closed years. The information necessary to determine whether a royalty rate in Year 1 or Year 2 is consistent with the arm's length principle – for example, sales in each year, or licensee profitability in each year – is available as of the end of each year, and may be audited in a normal course audit of each year. The HTVI approach may be suitable for assessing whether the royalty rate applied to sales in open years is appropriate in light of ex post outcomes and the presumptions that could be drawn from such outcomes.

Moreover, in the event that a tax administration is permitted under its domestic law statute of limitations to make adjustments to open tax years with respect to amounts that relate to closed tax years, we see no reason why the treaty partner should not make a corresponding adjustment irrespective of its statute of limitation rules if it agrees with the substance of the primary adjustment. The OECD Model Tax Convention provides that any agreement reached in the mutual agreement procedure shall be implemented notwithstanding any time limits in the domestic law of the Contracting States. The Final BEPS Report for Action 14 provides that countries should either adopt this language or, as an alternative, adopt alternative language that limits the time during which a country may make a primary adjustment. See Minimum Standard 3.3. Footnote 1 appears to permit to tax administrations to disagree as to the scope of their obligations under the mutual agreement procedure in a manner that is inconsistent with the minimum standards in the Final BEPS Report for Action 14. Such inconsistency will inevitably lead to double taxation.

Accordingly, the NFTC recommends modifying and expanding the language of footnote 1 to provide a more robust discussion of the extent to which adjustments made to open years may reflect amounts that relate to closed years. This discussion should address the interpretation of bilateral tax treaties that place time restrictions on the ability of countries to make primary adjustments, consistent with the alternative language outlined in Minimum Standard 3.3 of the Final BEPS Report for Action 14. More generally, the NFTC recommends that the Discussion Draft be revised to confirm the obligation of countries to endeavor to reach agreement under the mutual agreement procedure with respect to any primary adjustment justified on the basis of the HTVI approach and permitted under the applicable tax treaty. This latter recommendation could be implemented in the context of Example 3 or in a more fulsome discussion in paragraphs 31 or 32.

Sincerely,

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Appendix to NFTC Comments on BEPS Action 8: Implementation Guidance Hard-to-Value Intangibles

NFTC Board Member Companies:

ABB Incorporated
Amazon
Amgen
Applied Materials
Baxter International Inc.
British American Tobacco
Cargill
Caterpillar Incorporated
Chevron Corporation
Cisco Systems
Coca-Cola Company
ConocoPhillips, Inc.
Corning
Deloitte & Touche
Dentons US LLP
DHL North America
eBay, Inc.
E.I., du Pont de Nemours & Co.
Ernst & Young
ExxonMobil Corporation
FCA US LLC
Federal Express
Fluor Corporation
Ford Motor Company
General Electric Company
Google, Inc.
Halliburton Company
Hanesbrands Inc.
Hewlett-Packard Company
HP Inc
IBM Corporation
Johnson Controls
KPMG LLP
Mars Incorporated
Mayer Brown LLP
McCormick & Company, Inc.
Microsoft Corporation
Mondelez International Inc.
Oracle Corporation
Pernod Ricard USA
PMI Global Services Inc.
PricewaterhouseCoopers LLP
Procter & Gamble
Qualcomm Incorporated
Siemens Corporation
TE Connectivity
Toyota Motor Sales, USA Incorporated
United Parcel Service, Inc.
United Technologies
Visa, Inc.
Walmart Stores, Inc.