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**Transfer Pricing Treatment of Transactions with Hard-to-Value
Intangibles: Is BEPS Action 8 Based on the Arm's Length
Principle?**

by

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List of Abbreviations

Action 8	Recommendations set out in the OECD's Report 'Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports, OECD/G20 Base Erosion and Profit Shifting Project'
ALP	Arm's length principle
Associated enterprises	Parent and subsidiary enterprises as well as enterprises under common control. This term is used in line with the Model Convention's terminology
BEPS	Base erosion and profit shifting project
Commentaries	Commentaries to OECD Model Tax Convention on Income and on Capital (2014)
CUP	Comparable uncontrolled price method
Enterprise	Any legal entity, company, corporation or similar legal formation distinct from an individual. This term is used in line with the Model Convention's terminology
HTVI	Hard-to-Value Intangibles
IRS	The United States Internal Revenue Service
MNE	Multinational enterprise
Model Convention	OECD Model Tax Convention on Income and on Capital (2014)
OECD/G20	The Organisation for Economic Co-operation and Development and the Group of Twenty
PCL	Public comment letter
TP Guidelines	OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (2010)

Summary

This master's thesis analyses BEPS Action 8 recommendations in relation to transactions with hard-to-value intangibles. OECD has developed them with a view to ensure that transfer pricing outcomes of transactions with hard-to-value intangibles are aligned with value creation. The author discusses whether the proposed measure is in line with the arm's length principle – the internationally recognized foundation of transfer pricing. This discussion lays the ground for answering the next question: does the new measure lead to a risk of economic double taxation?

The analysis starts with an introduction into the concepts of the 'arm's length principle' and 'intangibles'. The author exposes intrinsic flaws of the arm's length principle and issues which intangibles bring into the transfer pricing.

BEPS Action 8 recommendations allow tax administrations to rely on information obtained *ex post* when assessing transfer prices set for transactions involving hard-to-value intangibles. The author concludes that this approach may deviate from the arm's length principle. As a result, associated enterprises transacting in relation to hard-to-value intangibles may face a risk of economic double taxation.

The present analysis proves to be unsuccessful in finding a balance between the application of the arm's length principle and the use of *ex post* outcomes by tax administrations. Even though OECD admits a problem in applying the arm's length principle to transactions with intangibles, it fails to take a forward-looking view. Rather, it unsuccessfully attempts to squeeze emerging issues into the long-standing framework premised on the arm's length principle. The discussion around hard-to-value intangibles shows that going beyond the existing standards may be an appropriate solution. Implementing the latter, however, would require revision of the majority of the world's tax treaties.

Prediction is very difficult, especially if it's about the future

Niels Bohr, Nobel laureate in Physics

1. INTRODUCTION

1.1. Background

The world of international tax will never be the same again. Launched in 2013, the OECD/G20 initiative on Base Erosion and Profit Shifting ('**BEPS**') is now marching at full speed. It will not be an exaggeration to claim that actual consequences of the BEPS initiative are yet to be discovered in the coming years, if not decades.

The idea for this paper emerged from the striking debate BEPS Action Plan recommendations¹ triggered among academics and practitioners. The recommendations address various aspects of international taxation 'to restore confidence in the [international tax] system and ensure that profits are taxed where economic activities take place and value is created.'² Transfer pricing rules are instrumental in achieving this goal and, not surprisingly, OECD/G20 devoted a significant piece of its work to them. This paper critically discusses BEPS recommendations on how to improve transfer pricing rules. Hard-to-value intangibles ('**HTVI**') – one of the most challenging aspects of transfer pricing – are at the core of this discussion.

The importance of intangibles in business increased tremendously over the last several decades. This phenomenon reflects 'a shift from industrial to post-industrial knowledge-based economies.'³ For instance, according to the research conducted by Ocean Tomo, LLC, 'in 1975 more than 80% of corporate value reflected in the S&P® 500 was tangible assets, while intangible assets comprised less than 20% of market capitalization. Today, the ratio of tangible to intangible assets has inverted – nearly 80% of corporate value resided in intangible assets.'⁴

The reality nowadays is that a growing number of new businesses are revolving around intangibles. Mature businesses also become dependent on them. They are now concentrating investments in intellectual capital, R&D, human capital and brand names.⁵ Intangibles help

¹ OECD, *Action Plan on Base Erosion and Profit Shifting* (OECD Publishing 2013) < <https://www.oecd.org/ctp/BEPSActionPlan.pdf> > accessed 2 June 2016.

² OECD, *Explanatory Statement*, OECD/G20 Base Erosion and Profit Shifting Project (OECD 2015), 4 < <http://www.oecd.org/ctp/beps-explanatory-statement-2015.pdf> > accessed 2 June 2016.

³ OECD, *The Knowledge-Based Economy* (OECD 1996), 18 < <https://www.oecd.org/sti/sci-tech/1913021.pdf> > accessed 2 June 2016.

⁴ Data obtained at the website of Ocean Tomo, LLC which, among others, maintains the Ocean Tomo 300® Patent Index (OT300) priced and published by the NYSE Euronext (NYSE Euronext: OTPAT). < <http://www.oceantomo.com/ocean-tomo-300/> > accessed 2 June 2016.

⁵ Michelle Markham, *Tax in a Changing World: The Transfer Pricing of Intangible Assets*, 40 *Tax Notes International* 10 (2005), 897.

businesses to prevail in a competitive environment because of their power to raise companies' profit margins and market shares.⁶

Multinational enterprises ('MNEs') are not exceptions to this global trend. Typical MNE consists of a number of enterprises ('**associated enterprises**') that perform so-called DEMPE functions in relation to intangibles (development, enhancement, maintenance, protection and exploitation).⁷ Intangibles are usually created and further exploited as a result of cooperation among associated enterprises. Such collaboration attracts attention from a tax perspective, especially when it entails cross-border transactions. In the latter case, transfer pricing rules come into play. Basically, they determine contributions made by each associated enterprise in relation to the intangible in order to fairly allocate profits (losses) derived from it.

In the globalized economy, MNEs shift intangibles across borders to jurisdictions where they could maximize the output from them. In this context, MNEs seek operational, human capital, tax and any other potential advantage in exploiting intangibles. As the practice of international tax planning shows, MNEs prefer to centralize intangibles in jurisdictions with a tax-friendly environment (i.e. low-tax jurisdictions). High-tax jurisdictions, at the same time, are at risk of losing tax revenues. It is not unusual that intangibles are first created (at least to a certain degree) in a high-tax jurisdiction and, afterwards, transferred to a low-tax jurisdiction to benefit from tax advantages.

In this context, transfer prices at which intangibles are shifted between associated enterprises are one of the main points of concern. Jurisdictions around the world have different corporate tax systems and tax rates which makes the reliability of transfer prices a sensitive issue.⁸ Price manipulations between associated enterprises may deprive one of the jurisdictions – most probably a high-tax jurisdiction where an intangible was (partially) created – of its fair share of tax revenue.

These concerns are the subject matter of the BEPS Action 8 recommendations⁹ ('**Action 8**') that were developed to address transfer pricing treatment of intangibles. Recommendations propose the new set of rules to be introduced into OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (2010)¹⁰ ('**TP Guidelines**') as a revision to its Chapter VI 'Special Considerations for Intangible Property.' The fundamental goal of Action 8 is to ensure that transfer pricing outcomes of transactions with intangibles are aligned with value creation.¹¹ Proposed rules regulate, among others, transactions with HTVI.

⁶ Monica Boos, *International Transfer Pricing: The Valuation of Intangible Assets* (Kluwer Law International 2003), 8.

⁷ John Henshall and Philippe G. Penelle, Intellectual property and controversy, *Int Tax Rev* 22 Mar 2016 < <http://www.internationaltaxreview.com/Article/3539714/Intellectual%ADproperty%ADand%ADcontroversy.html> > accessed 2 June 2016.

⁸ Boos (n 6), 2.

⁹ Although final version of BEPS Action 8 was presented along with Actions 9 and 10, for the convenience of the discussion in this paper it will be regarded as a separate BEPS Action.

¹⁰ OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD, 2010).

¹¹ OECD, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports*, OECD/G20 Base Erosion and Profit Shifting Project (OECD Publishing 2015), 9.

More specifically, Action 8 provides tax administrations with a special tool to deal more efficiently with HTVI transfer pricing issues which are discussed in this paper.

1.2. Purpose

The purpose of this paper is to analyse revisions to TP Guidelines proposed under Action 8. In particular, the analysis focuses on transfer pricing treatment of transactions with HTVI. The main issue associated with this type of transactions is that tax administrations are usually not well-positioned to assess the reliability of transfer prices at the time relevant transaction takes place. Tax administrations suffer from the information asymmetry since they lack ‘specialized knowledge, expertise and insight into the business environment in which the intangible is developed or exploited.’¹²

As a response to this disadvantage Action 8 developed an approach allowing tax administrations to assess transfer prices based on information about HTVI transactions obtained *ex post* (i.e. based on actual results that became known after the transaction was conducted). In other words, even though taxpayers conduct transactions with HTVI based on *ex ante* pricing (i.e. based on projections), tax administrations can subsequently reconsider transfer prices using *ex post* information.

Compatibility of the proposed approach with the arm’s length principle (‘**ALP**’) – the backbone of transfer pricing – raises significant concerns even though Action 8 explicitly states that it is consistent with the ALP.¹³ The hypothesis of this paper is that the proposed approach deviates from the ALP which could ultimately lead to economic double taxation.

To elaborate on the hypothesis stated above the author seeks answers to the following legal questions: Is the proposed *ex post* approach for transfer pricing treatment of HTVI transactions based on the ALP? Is there a risk that the proposed treatment leads to an economic double taxation if it deviates from the ALP?

1.3. Method and materials

The method of the legal-dogmatic research is used to analyse the legal questions stated above. The research is performed by analysing positive law as it stands now with the ultimate goal to examine internal consistency and coherence¹⁴ of the Action 8 recommendations with the existing positive law.

As a starting point, the research refers to authoritative sources in the field of international tax including, among others, OECD Model Tax Convention on Income and on Capital (2014)¹⁵ (‘**Model Convention**’) and relevant commentaries thereto (‘**Commentaries**’) as well as TP Guidelines. Although mentioned sources do not have binding legal force, they undoubtedly play the major role in formulating transfer pricing principles and norms both at

¹² *ibid*, para 6.186.

¹³ *ibid*, para 6.188.

¹⁴ S.C.W. Douma, *Legal research in international and EU tax law* (Wolters Kluwer 2014), 18.

¹⁵ OECD, *OECD Model Tax Convention on Income and on Capital: Condensed Version 2014* (OECD 2014) < http://dx.doi.org/10.1787/mtc_cond-2014-en > accessed 2 June 2016.

the international and domestic levels. '[T]hey can be regarded as a form of "soft" law directed at the [OECD] Member countries [...] and, as such, have great authority in [OECD] Member countries and are often complied with.'¹⁶ In practice tax administrations, courts and taxpayers often refer to Commentaries with a view to interpreting tax treaties.¹⁷

Recommendations developed within Action 8 are examined in light of mentioned above sources. The research also relies on relevant academic debate formulated in articles and books in the field of international taxation. Certain insights from tax practitioners are presented in this paper to illustrate the relevance of the discussed topic.

1.4. Delimitation

This paper is premised on the analysis of the OECD sources outlined above. It does not examine transfer pricing sources elaborated by the UN (e.g. UN Model Double Taxation Convention between Developed and Developing Countries and relevant commentaries thereto) or by a national law system of any particular jurisdiction.¹⁸ As an exception, the US transfer pricing rules are referred to in this research since they shed light on some issues associated with the *ex post* approach.

The subject-matter of this research is the proposed revisions to TP Guidelines based on Action 8 recommendations. The paper does not analyse other issues stemming from the combined BEPS Actions 8-10 report except for the cases where it is particularly relevant for examination of transfer pricing treatment of HTVI transactions.

Action 8 recommendations are expected to be complemented by the guidance on implementation of the *ex post* approach for pricing HTVI transactions in 2016.¹⁹ This paper does not take into account mentioned guidance since it is not publicly available as of the date this paper is completed (3 June 2016). At the same time, it may not be ruled out that some of the conclusions presented in this paper will be no longer valid once the guidance is published.

As a side note, the author admits that the application of the ALP in transfer pricing is now heavily debated (as will be described in section 2.2). This debate is especially relevant when it comes to transactions with intangibles. The present discussion, however, is premised on the fact that the ALP is (currently) an internationally recognized standard reflected in international and domestic tax laws.

¹⁶ S. Douma, F. A. Engelen (eds.), *The Legal Status of the OECD Commentaries* (Vol. 1 Conflict of Norms in International Tax Law Series, IBFD 2008), 258; see also for the similar position, for example, Andreas Bullen, *Arm's Length Transaction Structures. Recognizing and restructuring controlled transactions in transfer pricing* (Volume 20 in IBFD Doctoral Series 2011), 27-28, 31, 34.

¹⁷ Ulf Linderfalk, Maria Hilling, *The Use of OECD Commentaries as Interpretative Aids - The Static/Ambulatory-Approaches Debate Considered from the Perspective of International Law*, Vol 2015 Nordic Tax Journal 1 (Sep 2015), 34.

¹⁸ Although this paper does not examine national laws, it is worth mentioning that transfer pricing regulations of the majority of jurisdictions contain certain fundamental similarities. For instance, the ALP, a key discussion point in this paper, is included in national laws of the majority of jurisdictions which enacted transfer pricing rules. See, for example, Theresa Zinn, Nadine Riedel, Christoph Spengel, *The Increasing Importance of Transfer Pricing Regulations: A Worldwide Overview*, 42 *Intertax* 6&7 (2014), 355.

¹⁹ OECD Actions 8-10 (n 11), 64.

1.5. Outline

The analysis in this paper starts with the discussion of the concept of the ALP (chapter 2). The author refers to both academic and OECD sources. This discussion is supplemented with the criticism of the ALP which is particularly relevant in the context of HTVI transactions. The author further elaborates on the concept of intangibles and discusses issues which they bring into transfer pricing (chapter 3). Next, the paper focuses on the recommendations set out in Action 8 (chapter 4). The concept of HTVI is presented along with the proposed rules on how to treat HTVI transactions. The author further discusses the compatibility of the proposed treatment with the ALP. Finally, the paper elaborates on the risk of economic double taxation that may arise due to the incompatibility of the proposed HTVI regulations and the ALP (chapter 5).

2. ARM'S LENGTH PRINCIPLE

2.1. Concept of the ALP

The ALP is the cornerstone of transfer pricing. This principle is the starting point in transfer pricing regulations adopted at the international and domestic law levels. As Brauner refers to it, the '[ALP] is the heart, spirit and the foundation of the current international transfer pricing regime.'²⁰

In this section, the author tries to define the concept of the ALP acknowledging, however, that there is no worldwide consensus as to the content of this principle or as to the rules or the methods which would make a transaction regarded to be in accordance with it.²¹ Moreover, in some respects the ALP is subject to heavy criticism which will be briefly exposed in the next section.

The main rationale behind transfer pricing is to ensure that the profits or losses derived by associated enterprises from cross-border transactions are distributed in a way that is fair to both MNEs and jurisdictions in which they are doing business.²²

Independent parties that enter into (cross-border) transactions are driven by market forces outside of their control. Associated enterprises, to the contrary, may transact not paying enough attention to market forces or disregarding them at all. In other words, associated enterprises may manipulate transfer prices since the overall effect of their transactions will nonetheless be the same within the MNE. Such manipulation may affect associated enterprises' level of profits and, ultimately, the amount of tax they pay in relevant jurisdictions.²³

²⁰ Yariv Brauner, *Value in the Eye of the Beholder: The Valuation of Intangibles for Transfer Pricing Purposes*, 28 *Va. Tax Rev.* 79 (2008), 96 < <http://scholarship.law.ufl.edu/facultypub/18/> > accessed 2 June 2016.

²¹ Jens Wittendorff, *The Arm's-Length Principle and Fair Value: Identical Twins or Just Close Relatives?*, 62 *Tax Notes Intl* (18 Apr 2011), 237.

²² Jérôme Monsenego, *Introduction to transfer pricing* (Studentlitteratur 2013), 21.

²³ *ibid*, 17.

To address this risk the ALP was developed. Under this principle, transactions between associated enterprises are assessed, for transfer pricing purposes, as if they were conducted by independent parties.²⁴ The main idea is to simulate what would have been an arm's length price in a transaction between independent parties and then compare it with the actual transfer price set by associated enterprises. According to Schoueri, '[ALP] entails a legal fiction, i.e. related parties should be taxed as if they had traded according to the [ALP], and a legal presumption, i.e. the methods are designed to determine how independent parties would have traded at arm's length.'²⁵

Prices set by associated enterprises in deviation from the ALP must be disregarded for transfer pricing purposes. The tax assessment should, on the contrary, be based on a legal fiction as if associated enterprises transacted using arm's length prices. In such case a tax administration is authorized to adjust taxpayer's liabilities, i.e. to include in its profits, and tax accordingly, profits which have not accrued to the taxpayer because it was acting in deviation from the ALP.²⁶

Speaking more generally, ALP is a tool which tests the correspondence between MNE's overall profit and its members' shares of that profit as a return on contributions they have made to generate it.²⁷ As Wilkie puts it, '[t]he [ALP] reflects an expectation that the income reported by members of a commonly controlled, and operationally and economically integrated, corporate group should correspond in some observable or objectively noticeable way to their contributions to earning the shared entrepreneurial "firm" return.'²⁸

2.2. Criticism of the ALP

As noted earlier, the ALP is subject to criticism. On the one hand, it is aimed to test transactions between associated enterprises as if they were conducted by independent parties. On the other, it does not take into account a very important aspect which is intrinsic to an MNE – an integration of its members resulting in 'economies of integration.'²⁹ For that reason, not all transactions conducted by associated enterprises may be commercially rationale if they adhere to the ALP.

MNEs, according to Avi-Yonah, emerge from situations where the creation of 'an integrated hierarchical business organization is superior in efficiency terms when compared with the interaction of independent firms in the open market.'³⁰ Transfer prices within an MNE,

²⁴ It is generally recognized that there is an alternative approach to distributing profits or losses among associated enterprises – so-called 'unitary' or 'global formulary' approach. However, it will not be touched upon in this paper since, as stated in delimitations, the present discussion is built around the ALP.

²⁵ L.E. Schoueri, Arm's Length: Beyond the Guidelines of the OECD, 69 Bull. Intl. Taxn. 12 (2015), 704.

²⁶ Bullen (n 16), 3.

²⁷ W. Schön and K.A. Konrad (eds.), *Fundamentals of International Transfer Pricing in Law and Economics* (MPI Studies in Tax Law and Public Finance 1, Springer-Verlag 2012), 144.

²⁸ *ibid*, 152.

²⁹ Wittendorff (n 21), 239.

³⁰ Wolfgang Schön, Transfer Pricing, the Arm's Length Standard and European Union Law (MPI for Tax Law and Public Finance Working Paper 2011 – 08), 5 < http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1930237 > accessed 2 June 2016.

therefore, deviate from those which would have been set in a similar situation between independent parties.

He further claims that the fact that integrated MNEs exist is, of itself, an evidence that the ALP does not reflect economic reality. An MNE as a whole generates a higher return than its members would do separately; thus, using transfer pricing rules to distribute arbitrarily the portion of the return attributable to the MNE's integration distorts economic reality.³¹

Wilkie submits that the ALP is 'fundamentally antithetical to the economic, commercial and business characteristics' of dealings among associated enterprises. He claims that the ALP has always been associated with this issue, but it becomes even 'more prominent and disruptive' when it comes to transactions with intangibles.³²

'[T]he [ALP] is rather a legal than a commercial concept, trying to grant equal treatment to group companies and independent companies, but it cannot be defended as a business concept as it generically misses the efficiency requirements within the firm.'³³ Bullen supports this line of argumentation stating that the ALP was endorsed by OECD Member countries as well as non-Member countries to put MNEs and independent enterprises on an equal footing from a tax perspective.³⁴

Schoueri summarizes that there are two groups of objections against the ALP. The first one deals with 'a conceptual flaw underlying the [ALP]' (i.e. this flaw resonates with considerations presented above) while the second one concerns 'the feasibility of the [ALP]' (i.e. the possibility to apply it in practice, rather than challenging the principle as such).³⁵

This brief introduction to the criticism of the ALP creates a premise for the further discussion of the legal questions that are the subject-matter of this paper. As it would be shown further in this paper, the flaws of the ALP are notably relevant in analysing transfer pricing treatment of transactions with HTVI.

2.3. ALP in Model Convention

Model Convention is by far the most authoritative source which refers to the ALP. Although the Model Convention is regarded as a 'soft law', it is difficult to overestimate its influence in the field of international taxation. It comes into play when states negotiate bilateral double tax treaties and subsequently interpret them.³⁶

³¹ Reuven S. Avi-Yonah, *The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation*, Public Law and Legal Theory Working Paper Series (U of Michigan Working Paper No. 92, Sep 2007), 25 < http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1017524 > accessed 2 June 2016.

³² Schön (n 27), 137.

³³ Schön (n 30), 40.

³⁴ Bullen (n 16), 143.

³⁵ Schoueri (n 25), 698.

³⁶ It is fair to mention that there are some other models of double tax conventions (e.g. the UN Model Double Taxation Convention between Developed and Developing Countries and the U.S. Model Income Tax Convention). However, they refer to the ALP in the same way as Model Convention. Moreover, as stated in section 1.4 above, this paper focuses primarily on the OECD sources.

Model Convention refers to the ALP in Article 9 ‘Associated Enterprises’. Its first paragraph envisages readjustment of profits of associated enterprises (broadly speaking, parent and subsidiary companies as well as companies under common control³⁷) if they make conditions ‘in their commercial or financial relations which differ from those which would be made between independent enterprises.’³⁸ The legal construction ‘conditions which would be made between independent enterprises’ is interpreted in Commentaries as the ‘arm’s length terms.’³⁹

The adjustment contemplates inclusion into profits of an associated enterprise (an upward revision) of what was not earned because the enterprise transacted in deviation from the ALP. This ‘primary’ adjustment may lead to economic double taxation in the hands of its associated counterpart – ‘taxation of the same income in the hands of different persons’⁴⁰ – since the latter has already paid taxes in respect of profits which are now attributed to the first enterprise.

In this situation, the second paragraph of Article 9 comes into play. It stipulates so-called ‘corresponding’ adjustment, i.e. the state of the second enterprise ‘shall make an appropriate adjustment so as to relieve the double taxation.’⁴¹ This feature of Article 9 markedly distinguishes it from other Model Convention’s provisions which are, in most cases, aimed at relieving the juridical double taxation, i.e. ‘where the same income or capital is taxable in the hands of the same person by more than one State.’⁴² Article 9, on the contrary, regulates the taxation of profits of two different – but associated – enterprises in each of their residence states.⁴³

It is important to note that the contracting state grants the corresponding adjustment provided the primary adjustment in the other contracting state was made based on the ALP. In other words, Model Convention requires a contracting state to respect the primary adjustment made by the other state only if it was an ALP-based.⁴⁴

This conclusion is a very decisive point in the present paper as it lays the ground for the discussion of how important is the ALP in the field of international tax. To put it in another way, assume that the contracting state makes a primary adjustment in deviation from the ALP or, at least, the other contracting state considers that it goes beyond the ALP. Under such circumstances, the latter state may reject the corresponding adjustment which means, in essence, that the MNE faces economic double taxation of the same profit.

³⁷ OECD Model Tax Convention (n 15), 183 para 1.

³⁸ *ibid*, Art 9(1).

³⁹ *ibid*, 183 para 1.

⁴⁰ *ibid*, 184 para 5.

⁴¹ *ibid*, 184 para 5.

⁴² *ibid*, 323 para 1.

⁴³ See, for example, Bullen (n 16), 68; Ekkehart Reimer, Alexander Rust. (eds.), *Klaus Vogel on Double Taxation Conventions* (4th edn, Vol. 1 Wolters Kluwer 2015), 625.

⁴⁴ Schoueri (n 25), 710.

2.4. ALP in TP Guidelines

The concept of the ALP finds its further interpretation in TP Guidelines. They are regarded as an extension to Article 9 of Model Convention⁴⁵ and elaborate on the ALP's application in practice. TP Guidelines in conjunction with Article 9 have a significant influence on the interpretation of the ALP in national transfer pricing regulations. For OECD Member countries they are viewed as creating 'a "soft" obligation with which OECD Member countries are expected to comply.'⁴⁶

According to Wittendorff, the countries that apply transfer pricing regulations may be generally divided into four groups: (i) countries with explicit reference to Article 9 and TP Guidelines in the national transfer pricing regulations (the United Kingdom and Norway), (ii) countries where administrative rulings and legislative history lay the basis for relying on Article 9 and TP Guidelines (Australia, Belgium, Canada, Denmark, Germany, and the Netherlands), (iii) countries where Article 9 and TP Guidelines are not formally incorporated into national law, allowing the courts more flexibility in interpreting the ALP (Sweden), and (iv) the United States – the ALP is determined in autonomous national regulations 'that are primarily aimed at addressing and safeguarding U.S. interests rather than creating an international consensus.'⁴⁷

TP Guidelines define the ALP referring to the text of Article 9(1) of Model Convention stating that it 'is the international transfer pricing standard that OECD member countries have agreed should be used for tax purposes by MNE groups and tax administrations.'⁴⁸ According to TP Guidelines, the application of the ALP is relevant for transfer pricing purposes and should not influence contractual obligations between associated enterprises for non-tax purposes.⁴⁹

An important starting point which TP Guidelines provide for interpreting the ALP is a formulation of the rationale behind this principle. TP Guidelines state that one of the major reasons why the ALP is adopted is to put 'associated and independent enterprises on a more equal footing for tax purposes, [to avoid] the creation of tax advantages or disadvantages that would otherwise distort the relative competitive positions of either type of entity.'⁵⁰

To achieve that goal it is suggested to apply the 'separate entity approach.' This approach treats members of an MNE (associated enterprises) in their intra-group transactions as if they were 'independent enterprises operating in open markets.'⁵¹ In this context the ALP functions as a tool testing whether conditions made in transactions between associated enterprises correspond to the separate entity approach (i.e. whether independent enterprises would reach an agreement on similar conditions).

⁴⁵ Zinn (n 18), 354.

⁴⁶ Reimer (n 43), 612.

⁴⁷ Wittendorff (n 21), 238.

⁴⁸ OECD Transfer Pricing Guidelines (n 10), para 1.1.

⁴⁹ *ibid*, para 1.2.

⁵⁰ *ibid*, para 1.8.

⁵¹ *ibid*, para 6.

TP Guidelines admit the existence of cases where the ALP ‘is difficult and complicated to apply.’⁵² Among examples of such difficulties are transactions with unique intangibles which are of particular relevance for the discussion in this thesis. OECD claims that Action 8 recommendations are instrumental in coping with those difficulties. Proposed solutions, however, may go too far so as to put at risk correct application of the ALP.

3. INTANGIBLES

3.1. Intangibles in a transfer pricing context

The term ‘intangible’ may be found in a variety of contexts, and its content differs substantially from case to case. It is important to start with the introduction to the general concept of intangibles in a transfer pricing context. This will lay the basis for proper analysis of HTVI transactions and issues they bring into transfer pricing. The author starts with an academic definition of intangibles and further considers relevant provisions in TP Guidelines.

Starting from a very broad definition, Brauner notes that ‘intangibles are all the nonphysical, nonmonetary assets of a firm.’⁵³ He also refers to the definition formulated by Baruch Lev: ‘nonphysical sources of value (claims to future benefits) generated by innovation (discovery), unique organizational designs, or human resource practices.’⁵⁴

According to Boos, there is a lack of consensus as to which elements the term intangibles includes. She refers to this concept from legal, accounting, management, taxation and economic perspectives admitting that in each field definitions are purpose specific.⁵⁵ It would make little sense for this paper to define intangibles from all possible perspectives. Rather, it is sufficient to mention such an array of fields where the term is used to expose difficulties which academics and practitioners with different backgrounds encounter when dealing with transfer pricing treatment of intangibles.

A sound alternative to finding a comprehensive definition of intangibles is an attempt to categorize elements which they comprise. In a broad sense, scholars usually divide intangibles into three categories: intellectual capital, intangible assets and intellectual property.⁵⁶

According to Lagarden, the first group – ‘intellectual capital’ – consists of ‘intangibles such as company reputation and social capital; innovation; human capital; tacit knowledge or knowledge/information capital; organizational synergies; and non-contractual relations to customers or suppliers.’⁵⁷ Independent parties do not transact in relation to elements found in

⁵² *ibid*, para 1.9.

⁵³ Brauner (n 20), 87.

⁵⁴ *ibid*, 89.

⁵⁵ Boos (n 6), 16.

⁵⁶ Martin Lagarden, *Intangibles in a Transfer Pricing Context: Where Does the Road Lead?*, 21 *Intl. Transfer Pricing J.* 5 (2014), 333.

⁵⁷ *ibid*, 333.

this category; however, they may be used in functional or comparability analysis when establishing arm's length prices in controlled transactions.⁵⁸

The second group – 'intangible assets' – comprises 'corporate culture; know-how; operational guidelines; best practices; internal process set-ups or process-embedded technology; training and personnel development measures; and a successful management team.'⁵⁹ As in the previous category, it is difficult to imagine transactions between unrelated parties concerning the majority (or all) of those elements, but, again, they may be used in functional or comparability analysis.

'Intellectual property' includes intangibles such as 'patents, (trade)marks, different types of rights (e.g. copyrights and/or licences) covering the utilization of patents, of literary works, databases, exploration of natural resources or trade secrets or designs.'⁶⁰ What distinguishes these intangibles from the previous two categories is that they may be found in transactions between independent parties. Most of them may benefit from legal protection and be, one way or another, defined in the transactional documentation.⁶¹ Moreover, broadly speaking, intangibles in this category have a higher level of autonomy (separability) from their holders, i.e. such intangibles may be transferred from one party to another without losing (much of) their value.

Current version of TP Guidelines⁶² defines intangibles by a reference to the term 'intangible property' which:

[I]ncludes rights to use industrial assets such as patents, trademarks, trade names, designs or models. It also includes literary and artistic property rights, and intellectual property such as know-how and trade secrets. [TP Guidelines] concentrate on business rights, that is intangible property associated with commercial activities, including marketing activities. These intangibles are assets that may have considerable value even though they may have no book value in the company's balance sheet.⁶³

TP Guidelines divide intangibles into two broad categories – marketing and trade intangibles. The first category comprises, among others, 'trademarks and trade names [...], customer lists, distribution channels.'⁶⁴ They represent a specific group of intangibles that are aimed at the promotion of enterprise's products (services) or enhancing their commercial exploitation.

⁵⁸ *ibid*, 334.

⁵⁹ *ibid*, 334.

⁶⁰ *ibid*, 334.

⁶¹ *ibid*, 334.

⁶² As noted in section 1.1 above, Action 8 recommendations propose new version of TP Guidelines dedicated to intangibles (i.e. complete replacement of TP Guidelines' Chapter VI). In this section the author refers to provisions set out in the current version (as of 2010) of TP Guidelines.

⁶³ OECD Transfer Pricing Guidelines (n 10), para 6.2.

⁶⁴ *ibid*, para 6.3.

Marketing intangibles arise as a result of enterprise's 'market research or sales activities' and are generally exploited in relation to more than one product (service).⁶⁵

Trade intangibles include all other intangibles not found in the previous category, i.e. 'patents, know-how, designs, and models [...], as well as intangible rights that are themselves business assets transferred to customers or used in the operation of business.'⁶⁶ An enterprise typically exploits them to produce goods or provide services.⁶⁷

It is obvious that current version of TP Guidelines adheres to a relatively narrow concept of intangibles. In the context of the academic discussion presented above, it mainly relies on the category 'intellectual property', while not explicitly factoring in 'intellectual capital' and 'intangible assets'. It is worth noting at this point that Action 8 proposes an alternative, more universal solution. Namely, it defines intangibles in a broad sense without sticking to specific categories so as to allow taxpayers and tax administrations to use their own judgement on a case-by-case basis (this alternative approach will be discussed in section 4.1 below).

To complete this introductory section, the author outlines typical transactions between associated enterprises involving intangibles. Academic literature usually highlights three types of transactions with intangibles: (i) a sale and purchase, (ii) a license, and (iii) a joint development.⁶⁸ In the first two instances, one of the associated enterprises creates an intangible and further transfers (sells or licenses) it to a related party while in the latter case two or more associated enterprises contribute to the creation of an intangible and mutually benefit from it thereafter.

3.2. Transactions with intangibles: difficulties in applying the ALP

Discussion in the previous section shows a wide range of objects which may fall under the umbrella of 'intangibles'. In practice (or even in theory), independent parties do not transact in relation to objects belonging to categories 'intellectual capital' and 'intangible assets'. This, however, does not preclude associated enterprises from cooperating with each other in respect of such intangibles. As noted earlier, because of synergetic nature of MNEs, relations between associated enterprises may differ from those found between independent parties. This phenomenon creates significant obstacles in applying the ALP since the latter is premised on the legal fiction of what would have been agreed between independent parties in a similar situation.

Kane argues that intangibles are 'a sort of Achilles heel of the [ALP]' noting that they usually do not have ties to a specific location, are often unique and difficult to value.⁶⁹ He claims that the transfer pricing is currently facing a crisis because of transactions with intangibles. MNEs increasingly create value relying on intangibles and, hence, the number of instances where

⁶⁵ Isabel Verlinden, Yoko Mondelaers, *Transfer Pricing Aspects of Intangibles: At the Crossroads between Legal, Valuation and Transfer Pricing Issues*, 17 *Intl. Transfer Pricing J.* 1 (2010), 52.

⁶⁶ OECD *Transfer Pricing Guidelines* (n 10), para 6.3.

⁶⁷ *ibid*, para 6.3.

⁶⁸ See for instance, Boos (n 6), 43; Lagarden (n 56), 333.

⁶⁹ Mitchell A. Kane, *Transfer Pricing, Integration and Synergy Intangibles: A Consensus Approach to the Arm's Length Standard*, 6 *World Tax J.* (2014), 283.

the ALP is undermined rises. In this context, Kane argues that if the ALP is not capable of resolving transfer pricing issues associated with intangibles, ‘then one must confront the very real possibility that the [ALP] is unlikely to have long-term viability.’⁷⁰

Wilkie claims that when the ALP was developed it was aimed at tangible objects and well-defined intangibles. Nowadays, it is increasingly difficult to delineate where and how MNEs’ income is earned relying on conventional physical, separate entity principles that underlie international tax and treaty rules. He also contends that the issue with applying the ALP is first of all exacerbated because of increasing importance of intangibles in MNEs’ value creation.⁷¹

Action 8 recommendations are viewed as a response to that longstanding problem. How do the recommendations cope with this task in the context of HTVI is to be discussed in this paper. But first, let us outline main transfer pricing issues associated with intangibles. The lack of comparables is undoubtedly the major one. There are some other factors which undermine the application of the ALP. They either exacerbate the lack of comparables or complicate transfer pricing analysis where (at least) some comparables may be found.

Moreover, identifying intangibles for transfer pricing purposes is *per se* a challenging exercise since they are not always reflected in taxpayer’s accounts. This issue is also aggravated by the interplay of intangibles and the so-called ‘value drivers’. In academic literature, the latter are referred to as ‘an activity or organizational focus which enhances the perceived value of a product or service in the perception of the consumer and which therefore creates value for the producer.’⁷² Both intangibles and value drivers may contribute to the profitability of an enterprise. However, value drivers cannot be owned by an enterprise and, thus, transferred on the open market.⁷³ Hence, it is important to clearly distinguish intangibles and value drivers. The latter complicate the transfer pricing analysis and, as a result, may lead to arriving at non-arm’s length prices.

3.2.1. Lack of comparables

The ALP is used to test transfer prices set in controlled transactions as compared to those set by independent parties. One of the key aspects in this exercise is finding comparables that will serve as benchmarks. However, because of unique nature of the majority of intangibles, the search for comparables is considerably complicated, if ever, successful. Associated enterprises sometimes enter into transactions that independent parties would not undertake. This is especially relevant for transactions with intangibles where even OECD admits the difficulties in applying the ALP.⁷⁴

According to Brauner, ‘unique intangibles do not have markets and hence they are considered nontradable.’⁷⁵ Boos notes that comparables for intangibles rarely exist⁷⁶ and even if they can

⁷⁰ *ibid*, 283.

⁷¹ Schön (n 27), 137.

⁷² Verlinden (n 65), 50.

⁷³ *ibid*, 51.

⁷⁴ OECD Transfer Pricing Guidelines (n 10), para 1.11.

⁷⁵ Brauner (n 20), 91.

be found in some cases, there are, nonetheless, instances where the transfer of intangibles is possible only between associated enterprises because MNEs are unwilling to dispose of ‘certain unique intangibles with high profit potentials.’⁷⁷

Such absence of markets brings into question application of traditional transaction methods that are used in transfer pricing (i.e. CUP, resale price and cost plus methods). In this case, transactional profit methods may be better positioned to test transfer prices (especially the transactional profit split method as noted in Action 8⁷⁸). At the same time, some academics argue that the use of the profit split method is, by itself, the departure from the ALP.⁷⁹ Avi-Yonah submits that this kind of transfer pricing method ‘falls outside the traditional or narrow definition of the [ALP], but it still uses some form of comparables.’⁸⁰ The scope of this paper does not include the analysis of the transfer pricing methods to be applied to transactions with HTVI. The above discussion, however, shows that the absence of comparables constrains tax administrations and taxpayers to using transfer pricing methods that may deviate from the ALP or, at least, are not regarded as adhering to its traditional (narrow) concept.

3.2.2. Reliability of data

Even in cases where a market for certain intangibles exists, the reliability of data may be a great challenge. Independent parties operating in the market are very sensitive to disclosing the exact details of transactions with intangibles since they usually constitute their most valuable assets.⁸¹ At the same time, the comparability exercise requires plenty of information about uncontrolled transactions with intangibles. Little deviations may result in significant value differences that undermine the whole exercise. Hence, ‘the availability and quality of the data’ are crucial.⁸²

To give a rather simplified illustration of this issue it is worth referring to examples presented by Markham: ‘[o]ne hour of software programming does not necessarily equal another hour, while “in the pharmaceutical industry only one in 4000 synthesised compounds ever makes it to market and only 30% of those recover their development costs”.’⁸³

Moreover, independent parties often transfer intangibles as part of the disposal of a whole business.⁸⁴ Under such circumstances reliability of data about one of the transaction’s elements (i.e. intangible) may be highly questionable without paying attention to the overall transaction.

⁷⁶ Boos (n 6), 12.

⁷⁷ *ibid*, 9.

⁷⁸ OECD Actions 8-10 (n 11), para 6.57, 6.148-6.152.

⁷⁹ See, for example, Schoueri (n 25), 695; Robert Robillard, BEPS: Is the OECD Now at the Gates of Global Formulary Apportionment?, 43 *Intertax* 6&7 (2015), 447-448.

⁸⁰ Avi-Yonah (n 31), 3.

⁸¹ Brauner (n 20), 106.

⁸² Brauner (n 20), 106.

⁸³ Markham (n 5), 899.

⁸⁴ Brauner (n 20), 107.

3.2.3. Separability of intangibles

MNEs frequently combine intangibles with tangible or financial assets.⁸⁵ In such situations delineating properly the value of an intangible in the total value of a product may be quite a problematic task. This problem consequently affects the accuracy of a comparability exercise (if comparables are available at all).

For instance, if more or less standardised software is embedded into an electronic device (e.g. a smartwatch), finding comparables and applying the ALP could be a feasible task. However, the value of a device may also depend on an enterprise's marketing intangible (e.g. a well-respected brand). Delineating value of a particular brand, which by definition is unique, in the total value of a product could be a challenging exercise. As a result, the comparability analysis may be impracticable or, if taken, be highly unreliable because of its speculative adjustments.

Furthermore, if an intangible is inseparable from the rest of enterprise's assets, it is likely to be attributed to the category 'intellectual capital' or 'intangible assets', rather than 'intellectual property'. This means that the market for such intangible is unlikely to exist (as explained in section 3.1) and, as a result, the reliability of the transfer pricing analysis is again brought into question.

3.2.4. Valuation of intangibles

The value of intangibles usually lies in the future. According to Boos, '[i]t is the monetary value that someone would pay for the intangible asset now in return for the expectation of future economic profits accruing to the firm by its exploitation.'⁸⁶ The valuation of intangibles hence is based on estimations that 'might be subject to a high degree of uncertainty.'⁸⁷ It is fair to add that intangibles do not always prove to have value at all.

In essence, these features limit the valuation methods that may be applied to transactions with intangibles as opposed to tangible assets. Out of the three commonly recognized approaches – the cost, the market, and the income approach⁸⁸ – only the latter one may be the most appropriate for intangibles.⁸⁹ Namely, as illustrated earlier, there is no clear interplay between the cost of the intangible and the value that may be derived from it which makes the cost approach unreliable. Speaking about the market approach, the discussion above shows that in many cases markets for intangibles (especially for HTVI) do not exist. In this case, the income approach which relies on future variables could be the most reliable in appraising the potential of intangibles. This conclusion is in line with the Action 8 recommendations which, although do not endorse any specific valuation approach, state that the income-based valuation techniques may be particularly useful.⁹⁰

⁸⁵ *ibid*, 88-89.

⁸⁶ Boos (n 6), 9.

⁸⁷ *ibid*, 36.

⁸⁸ *ibid*, 73.

⁸⁹ *ibid*, 87.

⁹⁰ OECD Actions 8-10 (n 11), para 6.153, 6.156-6.157.

3.2.5. Conclusive remarks

In the discussion above the author exposes features of intangibles which complicate the transfer pricing analysis and, particularly, brings into question viability of the ALP. The lack of comparables puts into the limelight the very fundamental question of whether the ALP is still suitable to resolve all transfer pricing tasks. Action 8 is an attempt to deal with the phenomenon of intangibles. As will be discussed further, OECD submits that the solution both resolves the issues around transactions with intangibles and is still in line with the ALP. Discussion in this section shows the difficulties that Action 8 will encounter in practice. If one claims that the solution is based on the ALP, it should indeed follow the fundamentals of this principle – using comparables from the open market.

4. ACTION 8: TRANSACTIONS WITH HTVI

4.1. Revised concept of intangibles. HTVI

The primary goal of Action 8 is preventing base erosion and profit shifting that occurs due to moving intangibles among MNE's members.⁹¹ To this end, OECD provides a set of recommendations of how to tackle this problem, including special measures aimed at HTVI transfers.

As noted earlier, Action 8 is formulated in the form of a complete revision to the TP Guideline's Chapter VI 'Special Considerations for Intangible Property'. The analysis in this chapter starts with a brief outline of new regulations concerning HTVI. The author further provides a critical assessment of the Action 8 recommendations.

Action 8 admits difficulties in determining 'intangibles' for transfer pricing purposes. Too narrow definition could exclude certain items from the scope of this concept and, as a result, some transactions with intangibles will not attract separate remuneration for transfer pricing purposes, even though independent parties would agree on compensation in similar situations.⁹² In contrast, too broad definition could encompass certain elements which do not belong to this concept. Tax administrations or taxpayers may, therefore, argue that transactions with certain objects must be compensated while this is not the case in commercial relations between independent parties.⁹³

Addressing mentioned challenges Action 8 attempts to formulate the term 'intangibles' in a more or less universal way as:

[S]omething which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances.⁹⁴

⁹¹ BEPS Action Plan (n 1), 20.

⁹² OECD Actions 8-10 (n 11), para 6.5.

⁹³ *ibid*, para 6.5.

⁹⁴ *ibid*, para 6.6.

New rules depart from a mechanical replication of definitions that are common in accounting or legal field. Rather, they point out that circumstances of each case should be considered to ascertain whether a transaction between associated parties involve intangibles and, if yes, whether the use or the transfer of such intangibles would be compensated in a transaction between independent parties. In this respect, Action 8 furnishes tax administrations and taxpayers with a certain level of flexibility. Namely, it states that the concept of ‘intangibles’, for transfer pricing purposes, may differ from this concept used for general tax purpose;⁹⁵ that availability of legal, contractual or other forms of protection in respect of particular item is not a prerequisite for it to be treated as the intangible;⁹⁶ that an item may be characterized as an intangible even if it could not be transferred separately from other assets.⁹⁷

Action 8 mentions that intangibles could be divided into certain categories, e.g. marketing and trade intangibles (as discussed above in section 3.1). At the same time, it emphasizes that the categorization is only used to facilitate discussion of relevant transfer pricing matters.⁹⁸ Rather, tax administrations and taxpayers should adhere to the suggested flexible approach and ‘identify relevant intangibles with specificity’ in each case.⁹⁹

New rules further elaborate on the concept of ‘unique and valuable’ intangibles which is scarcely addressed in the current version of TP Guidelines. The following definition is introduced:

“Unique and valuable” intangibles are those intangibles (i) that are not comparable to intangibles used by or available to parties to potentially comparable transactions, and (ii) whose use in business operations (e.g. manufacturing, provision of services, marketing, sales or administration) is expected to yield greater future economic benefits than would be expected in the absence of the intangible.¹⁰⁰

This definition reflects, by itself, the challenge which unique intangibles pose to transfer pricing – the lack of comparables. Mentioned challenge is reiterated in the definition of HTVI which are the subject matter of this paper:

The term [HTVI] covers intangibles or rights in intangibles for which, at the time of their transfer between associated enterprises, (i) no reliable comparables exist, and (ii) at the time the transactions was entered into, the projections of future cash flows or income expected to be derived from the transferred intangible, or the assumptions used in valuing the intangible are highly uncertain, making it difficult to predict the level of ultimate success of the intangible at the time of the transfer.¹⁰¹

⁹⁵ *ibid*, para 6.7.

⁹⁶ *ibid*, para 6.8.

⁹⁷ *ibid*, para 6.8.

⁹⁸ *ibid*, para 6.16.

⁹⁹ *ibid*, para 6.16.

¹⁰⁰ *ibid*, para 6.17.

¹⁰¹ *ibid*, para 6.189.

Definition of HTVI exposes two major issues: (i) the lack of comparables (the issue already raised in the context of ‘unique and valuable’ intangibles) and (ii) difficulties with predicting ultimate success of the intangible at the time associated enterprises transact.

To illustrate this concept, Action 8 provides for some instances where HTVI may be found. In particular, it refers to the following situations: (a) transfer of intangible which is only partially developed at the time of transfer; (b) intangible is not expected to be exploited commercially until several years following the transaction; (c) intangible is not regarded as HTVI but is integral to the development or enhancement of HTVI; (d) intangible is expected to be exploited in a manner that is novel at the time of the transfer (this makes projections highly uncertain); (e) HTVI has been transferred to an associated enterprise for a lump sum payment; (f) intangible is used or developed under a cost contribution arrangement.¹⁰²

4.2. HTVI: new approach

Action 8 introduces special rules to treat transactions with HTVI. They equip tax administrations with an additional tool to examine transfer prices associated enterprises set in relation to the transfer or the use of HTVI. This tool is the *ex post* assessment: verifying transfer prices based on the actual outcome of the transaction, rather than projections made by parties at the time the transaction was made.

The rationale behind this special measure is that tax authorities suffer from information asymmetry when assessing transfer prices in HTVI transactions. Namely, tax administrations may not have ‘specialized knowledge, expertise and insight into the business environment in which the intangible is developed or exploited.’¹⁰³ OECD argues that authorities are, as a rule, dependent on information provided by taxpayers which makes it difficult for them to reliably examine relevant transfer prices.¹⁰⁴

As an example, assume that an enterprise in a high-tax jurisdiction (A Corp.) has developed unique software which is a novelty in the market. Based on objective assumptions, known to the A Corp. only, it forecasts that potential revenue attributable to the software could be in a range from \$60Mio to \$100Mio. Afterwards, A Corp. grants an exclusive license to use, copy, modify, and distribute the software to its associated enterprise (B Corp.) in a low-tax jurisdiction. The license is granted for ten years for a lump sum payment of \$1Mio which – A Corp. claims based on the well-prepared transfer pricing documentation – is the arm’s length price.

In such situation it could be difficult, if ever possible, for the tax administration to reliably verify *ex ante* the software license’s transfer price set by A Corp. Assume further that within several years B Corp. distributed software to customers for approximately \$100Mio (i.e. *ex post* result). In the course of a subsequent tax audit of A Corp. in the high-tax jurisdiction it claims that the success of the software was unpredictable. The product attracted a

¹⁰² *ibid*, para 6.190.

¹⁰³ *ibid*, para 6.186.

¹⁰⁴ *ibid*, para 6.186.

considerably higher level of demand than could have been reasonably anticipated at the time the license was granted to B Corp.

Here, the software is a clear-cut example of HTVI. Firstly, there are no reliable comparables because the software is a novelty in the market. Secondly, for the same reason, the projections of income expected are highly uncertain at the time the license is granted. Although we know that A Corp. was able to forecast potential revenue, it was unwilling to disclose the objective forecast in the transfer pricing documentation. The tax administration, however, was not in a position to reliably verify the forecast due to lack of the insight into the novelty software's potential.

Although this example shows quite exaggerated difference between *ex ante* and *ex post* results, it perfectly exposes (i) information asymmetry which – OECD claims – tax administrations experience in practice, and (ii) challenges that HTVI bring into transfer pricing. Moreover, this example does not necessarily reflect the reliability of projections associated enterprises made in practice. Rather, it facilitates one in understanding the rationale put forth by the OECD.

Action 8 is intended to ensure that tax administrations are not disadvantaged because of an information asymmetry. To this end, new rules allow tax administrations to reassess taxpayer's liabilities if *ex ante* projections differ from *ex post* results. The difference, *per se*, is not a ground to make the reassessment. It is an indicator ('presumptive evidence') that uncertainties existed when taxpayers made *ex ante* projection.¹⁰⁵ Based on such presumptive evidence, tax administrations may examine whether *ex ante* projections comply with the ALP using actual (*ex post*) results of the transaction:

For [HTVI], information asymmetry between taxpayer and tax administrations [...] may be acute and may exacerbate the difficulty encountered by tax administrations in verifying the arm's length basis on which pricing was determined [...]. As a result, it will prove difficult for a tax administration to perform a risk assessment for transfer pricing purposes, to evaluate the reliability of the information on which pricing has been based by the taxpayer, or to consider whether the intangible or rights in intangibles have been transferred at undervalue or overvalue compared to the arm's length price, until *ex post* outcomes are known in years subsequent to the transfer.¹⁰⁶

In these circumstances, the tax administration can consider *ex post* outcomes as presumptive evidence about the appropriateness of the *ex ante* pricing arrangements.¹⁰⁷

In essence, tax administrations are allowed to verify *ex ante* pricing arrangements based on *ex post* results. In this verification exercise tax administrations examine '[i] whether the taxpayer appropriately took into account reasonably foreseeable developments or events at

¹⁰⁵ *ibid*, para 6.187.

¹⁰⁶ *ibid*, para 6.191.

¹⁰⁷ *ibid*, para 6.192.

the time of the transaction, and [ii] the reliability of the information used *ex ante* in determining the transfer price for the transfer of such intangibles or rights in intangibles.’¹⁰⁸

Action 8 contemplates four exemptions under which *ex post* assessment does not apply to HTVI transactions.¹⁰⁹ Therefore, tax administrations must rely on *ex ante* pricing arrangements if they audit transactions falling under one of the exemptions. They could be condensed as follows:

i) Well-elaborated defence files

Taxpayer can satisfactorily show (i) what was foreseeable at the time of the transaction and how this forecast is reflected in the pricing assumptions, and (ii) that the difference between *ex ante* projections and *ex post* results is due to unforeseeable developments or events;¹¹⁰

ii) Advance pricing arrangement

The transfer of HTVI is covered by an advance pricing arrangement (‘**APA**’);

iii) Safe harbours

The deviation of the *ex post* result from the *ex ante* pricing is within the 20% safe-harbour (i.e. *ex post* results fall within 80% - 120% range of *ex ante* projections);

iv) Commercialisation

Five years of commercialisation has passed since ‘the year in which the HTVI first generated unrelated party revenues for the transferee’¹¹¹ provided the deviation of the *ex post* result from the *ex ante* pricing during the commercialization period was within the 20% safe-harbour.

The *ex post* approach may be summarized in the following algorithm. When tax administrations audit transactions involving HTVI they may rely on *ex post* results because they usually suffer from information asymmetry. However, taxpayers may rebut reliance on *ex post* results provided they can prove that the difference is due to developments unforeseeable at the time *ex ante* projections were made (well-elaborated defence file) or rely on other exemptions (APA, 20% safe-harbour, or five years commercialisation period).

4.3. *Ex post* assessment: a threat to the ALP?

Action 8 contains a bold statement that the proposed approach – verifying transfer prices set for HTVI based on *ex post* results – is consistent with the ALP.¹¹² This paper critically examines this statement.

¹⁰⁸ *ibid*, para 6.188.

¹⁰⁹ *ibid*, para 6.193.

¹¹⁰ *ibid*, para 6.194.

¹¹¹ *ibid*, para 6.193.

¹¹² *ibid*, para 6.187.

According to the proposed rules, the transfer pricing treatment of HTVI transactions is different from a mere use of hindsight (i.e. simply taking *ex post* results for tax assessment purposes). Namely, Action 8 states that tax administrations must take into account ‘whether the information on which the *ex post* results are based could or should reasonably have been known and considered by the associated enterprises at the time the transaction was entered into.’¹¹³ The author interprets this statement as requiring a two-fold assessment during a tax audit. First, a tax administration looks at projections made by a taxpayer *ex ante* to ascertain whether the developments or events that led to *ex post* results were reasonably foreseeable. Second, if they were reasonably foreseeable but not factored in, the tax administration reassesses taxpayer’s liabilities based on *ex post* results.

In transfer pricing, reliance on *ex post* outcomes may lead to the deviation from the ALP. The latter is based on modelling of what independent parties would have agreed on in a situation similar to the controlled transaction. It is difficult to imagine how independent parties dealing with HTVI could be aware of *ex post* outcomes at the time relevant transaction is made. The concept of HTVI, as such, implies that parties are uncertain about potential outcomes. They rely on their own projections and transact once both sides reach a consensus with respect to such projections.

Moreover, TP Guidelines may be interpreted in a way that they generally disallow the use of *ex post* outcomes, but require looking at what independent parties would have projected *ex ante*. For example, the following provisions regulating the comparability analysis may be indicative of such interpretation:

[...] The mere existence of uncertainty *should not require an ex post adjustment* without a consideration of what independent enterprises would have done or agreed between them.¹¹⁴ (emphasis added)

Data from years following the year of the transaction may also be relevant to the analysis of transfer prices, but care must be taken *to avoid the use of hindsight*. [...]¹¹⁵(emphasis added)

Current rules in TP Guidelines relating to intangibles contemplate an approach which is contradictory to the *ex post* assessment. Namely, paragraph 6.32 of the current TP Guidelines reads:

When tax administrations evaluate the pricing of a controlled transaction involving intangible property where valuation is highly uncertain at the outset, the arrangements that would have been made in comparable circumstances by independent enterprises should be followed. Thus, if independent enterprises would have fixed the pricing

¹¹³ *ibid*, para 6.188.

¹¹⁴ OECD Transfer Pricing Guidelines (n 10), para 3.73.

¹¹⁵ *ibid*, para 3.74.

based upon a particular projection, *the same approach should be used by the tax administration in evaluating the pricing. [...]* ¹¹⁶ (emphasis added)

Action 8 proposes similar approach in relation to ‘transactions involving intangibles for which valuation is highly uncertain’:

[...] When valuation of an intangible or rights in an intangible at the time of the transaction is highly uncertain, the question arises as to how arm’s length pricing should be determined. The question should be resolved, both by taxpayers and tax administrations, by reference to *what independent enterprises would have done in comparable circumstances to take account of the valuation uncertainty in the pricing of the transaction.*¹¹⁷ (emphasis added)

The transactional profit split method rules¹¹⁸ also refer to the *ex ante* approach noting that the use of actual (i.e. *ex post*) results may be contrary to the ALP:

When a tax administration examines the application of the method used *ex ante* to evaluate whether the method has reliably approximated arm’s length transfer pricing, it is critical for the tax administration to acknowledge that the taxpayer could not have known what the actual profit experience of the business activity would be at the time that the conditions of the controlled transaction were established. Without such an acknowledgement, the application of the transactional profit split method could *penalize or reward a taxpayer by focusing on circumstances that the taxpayer could not reasonably have foreseen.* Such an application would be contrary to the arm’s length principle, because independent enterprises in similar circumstances could only have relied upon projections and *could not have known the actual profit experience.*¹¹⁹ (emphasis added)

One may raise a counterargument in response to the critique presented above: HTVI are an exceptional type of intangibles and deserve the treatment which differs from the general approach – relying on *ex ante* projections – set out in TP Guidelines. Indeed, this counterargument is in line with the rationale stated in Action 8.

The counterargument, as such, is valid and sound. As discussed earlier, HTVI bring challenges into transfer pricing. Tax administrations are poorly equipped to deal with information asymmetry associated with HTVI. However, this problem should not endorse the departure from the ALP as long as transfer pricing is based on this principle.

An academic debate revolving around the *ex post* assessment emerged long before the BEPS project was initiated. According to Bullen, the controversial issue was ‘whether tax examiners are authorized to take into account information known at the time of the

¹¹⁶ *ibid*, para 6.32.

¹¹⁷ OECD Actions 8-10 (n 11), para 6.181.

¹¹⁸ In this context it is worth noting that Action 8, in essence, acknowledges that the transactional profit split method could be one of the most appropriate methods when dealing with intangibles. See, for instance, OECD Actions 8-10 (n 11), paras 6.141, 6.142, 6.145, 6.148-6.152.

¹¹⁹ OECD Transfer Pricing Guidelines (n 10), para 2.128.

assessment, but neither known nor reasonably foreseeable at the time the controlled transaction was entered into.’¹²⁰ This issue unfolds into three questions: whether tax administrations may take into consideration (i) the level of income actually generated, (ii) whether forecasted risks actually materialized, and (iii) whether particular activity or arrangement was successful.¹²¹

Two independent parties negotiating an agreement base their positions on the circumstances that exist at the time of the negotiations.¹²² Thus, the *ex post* assessment does not have a sound relationship to the situation facing independent parties negotiating an agreement; this makes *ex post* unacceptable under the ALP.¹²³ Bullen concludes that, although TP Guidelines do not explicitly mention *ex-ante* approach as a general principle, the overall interpretation of this source confirms the *ex-ante* approach and discourages the use of hindsight.¹²⁴ He also mentions that domestic laws of a number of countries interpret the ALP as requiring the *ex ante* approach (namely, Australia, Canada, the Netherlands, New Zealand, Norway, South Africa, Sweden, and the United Kingdom).¹²⁵ Some countries, however, rely on *ex post* results in certain cases: the United States (commensurate with income standard) and Germany (mechanical imputation of price adjustment clauses).¹²⁶ The approach used in the United States is discussed in section 4.5 below.

Henshall also asserts that hindsight should not be used by tax administrations or MNEs: ‘Transfer prices frequently will be determined ahead of time by reference to best available forecasts; [...] it is not appropriate to require transfer pricing adjustments computed in the light of actual, unforeseen (later) events.’¹²⁷ He further refers to a lifecycle of IP noting that information available to the parties as well as their risk profiles are changing over the whole life of the intangible. Therefore, it is crucial in transfer pricing exercise to rely on data that would have been available to the parties at the time transaction was made.¹²⁸

Mentioned above argumentation corresponds to the commentaries Kofler provides on the application of the ALP. He submits that this principle should be applied ‘on the basis of the circumstances prevailing and information reasonably available at the time of the transaction.’¹²⁹

Speculating further on what could have happened in a transaction between independent enterprises it would be fair to claim that bad deals sometimes occur between unrelated parties. There is no ground to ignore such probability in a properly constructed transaction

¹²⁰ Bullen (n 16), 306.

¹²¹ *ibid*, 306-307.

¹²² *ibid*, 309.

¹²³ *ibid*, 309.

¹²⁴ *ibid*, 310-311.

¹²⁵ *ibid*, 313.

¹²⁶ *ibid*, 326, 333.

¹²⁷ John Henshall, *Global Transfer Pricing: Principles and Practice* (2nd edn, Bloomsbury Professional 2013), para 2.21.

¹²⁸ *ibid*, para 6.98.

¹²⁹ Reimer (n 43), 639.

between associated enterprises.¹³⁰ Using hindsight in such situation (i.e. protecting one of the associated enterprises from the bad deal) would mean departing from the ALP.¹³¹ It is difficult to see how the proposed *ex post* assessment factors in the probability of bad deals' occurrence.

Referring again to Bullen, he contends that there is no logical explanation of why the lack of comparables endorses the use of *ex post* results under the ALP. Rather, such approach appears to be easy, but non-arm's length, solution to a problem which intangibles create for transfer pricing area: 'the actual [*ex post*] profits generated by the transferred intangible are generally easier to determine than the price which would have been paid by a comparably placed independent transferee.'¹³²

4.4. Commentaries from practitioners

This paper complements academic debate on *ex post* assessment with commentaries from practitioners.¹³³ They may prove useful in comprehending the array of practical challenges that the *ex post* approach poses to the ALP. Moreover, commentaries play an important role in the present analysis since OECD has not provided empirical evidence of the use of *ex post* outcomes in third party transactions to substantiate its proposal under Action 8. The author does not claim that the commentaries have the value of empirical research. Rather, they show that such research, if conducted, would have dispersed many concerns around (in)compatibility of the *ex post* approach and the ALP.

4.4.1. Intrinsic uncertainty in forecasting

Ex ante projections are always associated with uncertainties and many MNEs struggle with forecasting, even for an established business. This fact is equally the case for transactions between associated enterprises and third party transactions. The practice shows a number of examples where businesses invested poorly in intangibles, but results exceeded expectations and *vice versa*. Hence, in most, if not all, cases *ex ante* projections will be (significantly) different from *ex post* results which may lead to a massive reassessment of related party transactions with HTVI under Action 8. Moreover, if a tax administration looks back at *ex ante* projections and verifies them with the benefit of hindsight, there is a risk to misstate values valid at the time the transaction was made because hindsight could under/overestimate perceived risks attached to the businesses/investments at that time.¹³⁴

¹³⁰ D.R. Wright et al., The BEPS Action 8 Final Report: Comments from Economists, 23 Intl. Transfer Pricing J. 2 (2016), 104.

¹³¹ *ibid*, 104.

¹³² Bullen (n 16), 326.

¹³³ On 4 June 2015, OECD invited public comments with respect to the discussion draft on Action 8 (in the context of HTVI); see < <http://www.oecd.org/ctp/transfer-pricing/release-discussion-draft-beps-action-8-hard-to-value-intangibles.htm> > accessed 2 June 2016. OECD further compiled received comments and made them publicly available; see < <https://www.oecd.org/tax/transfer-pricing/public-comments-beps-action-8-hard-to-value-intangibles.pdf> > accessed 2 June 2016.

¹³⁴ See, for example, PCL from CBI/Neil Anthony to the OECD/Andrew Hickman (17 June 2015); PCL from Grant Thornton International Ltd/Francesca Lagerberg to the OECD/Andrew Hickman (17 June 2015); PCL from BIAC/William Morris to the OECD/Andrew Hickman (18 June 2015); PCL from CIOT to the

4.4.2. Price adjustments are not widespread in practice

According to practitioners, adjustment of prices *post factum* is rare in dealings between independent parties. In many cases, commercial contracts do not foresee price adjustment clauses. Moreover, it would be naïve to assume that an independent party which has benefited from a difference between *ex ante* projections and *ex post* results would agree to renegotiate the price. In some cases, a losing party would not even be asking for the renegotiation in order not to impact the broader commercial relationships. It is quite possible that unrelated parties allocate risks of deviation from *ex ante* projections to the party acquiring the intangible. This allocation would be reflected in the intangible's price. There is no need in such situation to agree on a price adjustment clause since the buyer is acquiring, *inter alia*, the risks attached to the intangible (i.e. the risk that the *ex post* results deviate from *ex ante* projections).¹³⁵

4.4.3. Value of intangibles is dynamic

Once intangible is transferred from one party to another, the latter could contribute significantly to increase or decrease of intangible's value. This is especially the case when early-stage intangibles are transferred (although this could equally apply to mature intangibles). The difference between *ex ante* projections and *ex post* results could, therefore, arise from the success or failure of buyer's/licensee's efforts to develop, enhance, maintain, protect and exploit the intangibles (so-called DEMPE functions). In the context of HTVI, there is a risk that *ex post* approach will ignore post-transfer DEMPE functions.¹³⁶

4.5. US commensurate with income standard

The proposed *ex post* approach resembles in many respects the 'commensurate with income standard' found in the US tax law. The latter has had a significant influence on the transfer pricing regulations developed under the auspices of OECD.¹³⁷ Bullen claims that '[m]any OECD developments in the area of transfer pricing are either directly influenced by US

OECD/Andrew Hickman (18 June 2015); PCL from BUSINESSEUROPE/James Watson to the OECD/Andrew Hickman (18 June 2015); PCL from KPMG International to the OECD/Andrew Hickman (18 June 2015).

¹³⁵ See, for example, PCL from FIDAL/François Vincent and Pascal Luquet to the OECD/Andrew Hickman (15 June 2015); PCL from ANIE Federazione/Maria Antonietta Portaluri to the OECD/Andrew Hickman (16 June 2015); PCL from BDI/Berthold Welling and Dr. Karoline Kampermann to the OECD/Andrew Hickman (without date); PCL from BIAC/William Morris to the OECD/Andrew Hickman (18 June 2015); PCL from BUSINESSEUROPE/James Watson to the OECD/Andrew Hickman (18 June 2015); PCL from Deloitte LLP/Bill Dodwell to the OECD/Andrew Hickman (18 June 2015); PCL from GSK/Melissa Geiger to the OECD/Andrew Hickman (18 June 2015); PCL from Loyens & Loeff N.V./Harmen van Dam, Paul Lankhorst and Lucia Sahin to OECD/Andrew Hickman (18 June 2015); PCL from CIOT to the OECD/Andrew Hickman (18 June 2015).

¹³⁶ PCL from ANIE Federazione/Maria Antonietta Portaluri to the OECD/Andrew Hickman (16 June 2015); PCL from BUSINESSEUROPE/James Watson to the OECD/Andrew Hickman (18 June 2015); PCL from EBIT to the OECD/Andrew Hickman (18 June 2015); PCL from KPMG International to the OECD/Andrew Hickman (18 June 2015); PCL from PwC/Isabel Verlinden and Adam M. Katz to the OECD/Andrew Hickman (18 June 2015).

¹³⁷ Bullen (n 16), 15.

domestic law or the result of compromise between the United States and the other OECD Member countries.¹³⁸ The *ex post* approach seems to be not an exception.

The commensurate with income standard was introduced into the US tax law under the 1986 Tax Reform Act¹³⁹ ‘in an effort to deal with the transfer of intangibles between a parent company and its tax haven subsidiaries.’¹⁴⁰ The standard reads as follows:

In the case of any transfer (or license) of intangible property [...], the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.¹⁴¹

The US Internal Revenue Service (‘IRS’) elaborated on the standard laying out the rules on periodic adjustments of transfer prices set for intangibles.¹⁴² Under the general rule:

If an intangible is transferred under an arrangement that covers more than one year, *the consideration* charged in each taxable year *may be adjusted* to ensure that it is commensurate with the income attributable to the intangible. [...] The determination in an earlier year *that the amount charged for an intangible was an arm's length amount will not preclude* the district director in a subsequent taxable year *from making an adjustment* to the amount charged for the intangible in the subsequent year.¹⁴³ (emphasis added)

In essence, this standard – also known as the ‘super-royalty’ provision¹⁴⁴ – requires taxpayers to consider actual profit realized from the exploitation of the intangible that was transferred in the controlled transaction.¹⁴⁵ If the actual outcome differs from the initial transfer price, the latter must be adjusted (even though it could have been initially determined as the arm’s length price). As Brauner interprets it, ‘taxpayers are required to make “periodic adjustments” (normally on an annual basis) so that the transfer price (royalty) would be commensurate with income.’¹⁴⁶

The US Treasury Regulations require the adjustments under the commensurate with income standard to be consistent with the ALP.¹⁴⁷ This is hardly achievable – if at all – since, as many scholars claim, the standard *per se* is not in line with the ALP.¹⁴⁸ Bullen views the commensurate with income standard as the use of hindsight.¹⁴⁹ Wittendorff claims that periodic adjustments under this standard fall out of the scope of Article 9(1) of Model

¹³⁸ *ibid.*, 15.

¹³⁹ Michelle Markham, *The Transfer Pricing of Intangibles* (Kluwer Law International 2005), 76.

¹⁴⁰ Bibiana A. Cruz Martínez, *The Arm’s Length Standard vs the Commensurate with Income Standard: Transfer Pricing Issues in the Valuation of Intangible Assets*, 2 U.P.R. Business Law Journal 2 (2011), 308.

¹⁴¹ 26 U.S. Code § 482 < <https://www.law.cornell.edu/uscode/text/26/482> > accessed 2 June 2016.

¹⁴² Treas. Reg. (US) § 1.482-4(f)(2).

¹⁴³ Treas. Reg. (US) § 1.482-4(f)(2)(i).

¹⁴⁴ Markham (n 139), 76.

¹⁴⁵ Brauner (n 20), 100.

¹⁴⁶ Brauner (n 20), 100.

¹⁴⁷ Treas. Reg. (US) § 1.482-4(f)(2)(i).

¹⁴⁸ See, for example, Markham (n 139), 78; Avi-Yonah (n 31), 19; Brauner (n 20), 100; Wittendorff (n 21), 227; Bullen (n 16), 327; Cruz Martínez (n 140), 309.

¹⁴⁹ Bullen (n 16), 327.

Convention.¹⁵⁰ Moreover, OECD criticized periodic adjustments as departing from the ALP at the time IRS was working on the draft of relevant Treasury Regulations.¹⁵¹

Notably, Avi-Yonah exposes that the lawmakers in the US initially admitted incompatibility of the commensurate with income standard with the ALP: ‘the House did not pretend that the “commensurate with income” standard was compatible with the [ALP]. The report states the transferor of intangibles in a multinational was looking to its equity investment, “rather than to ‘arm’s length’ factors,” to recuperate its cost [...]. Thus, even if a perfect comparable could be found in which the same intangible was transferred to an unrelated party in the same circumstances for a fixed royalty rate, the provision would still require the allocation of “super-royalties” to a related party transferor.’¹⁵²

The *ex post* approach proposed under Action 8 differs from the commensurate with income in that it is not applicable if the transfer price was initially set as the arm’s length price. However, the US standard clearly displays the risks which post-assessment imposes on the ALP. Although OECD was initially against this approach, the latter slowly permeates into its transfer pricing rules. The vagueness of the *ex post* rules proposed under Action 8 may eventually equip tax administrations with the tool very similar to the one used in the US.

5. TRANSACTIONS WITH HTVI: RISK OF ECONOMIC DOUBLE TAXATION

5.1. Deviation from the ALP: analysis of consequences

Now that the issues related to the proposed treatment of HTVI transactions have been exposed, it is appropriate to analyze implications stemming from the new approach. As the discussion in the previous chapter shows, the *ex post* approach may deviate from the ALP. Although Action 8 claims that the proposed measure is consistent with the ALP, its application in practice may go far beyond this internationally recognized standard.

ALP is the standard which lays the ground for adjustments to profits of associated enterprises under Model Convention¹⁵³ (as discussed earlier in section 2.3). Namely, if the transfer price set in the controlled transaction deviates from the arm’s length price, tax administration in a relevant contracting state may rewrite accounts of the associated enterprise so as to align them with true taxable profits¹⁵⁴ – primary adjustment in the form of upward revision. In this case, tax administration in the other contracting state shall make the corresponding adjustment in the accounts of the related party in the form of downward revision.¹⁵⁵ However, Model Convention requires the corresponding adjustment from the other contracting state only in case the primary adjustment was based on the ALP.¹⁵⁶

¹⁵⁰ Wittendorff (n 21), 227.

¹⁵¹ Bullen (n 16), 512.

¹⁵² Avi-Yonah (n 31), 19.

¹⁵³ OECD Model Tax Convention (n 15), 183 para 1.

¹⁵⁴ *ibid*, 183 para 2.

¹⁵⁵ *ibid*, 184 para 5.

¹⁵⁶ *ibid*, Art 9(2).

The present paper demonstrates that the tax administration rewriting accounts of the associated enterprise may arrive at the non-arm's length price if they rely on the *ex post* approach. Under such circumstances authorities in the other contracting state will be entitled to reject the corresponding adjustment. In other words, under Action 8 associated enterprises may face a situation of economic double taxation not covered by Model Convention.

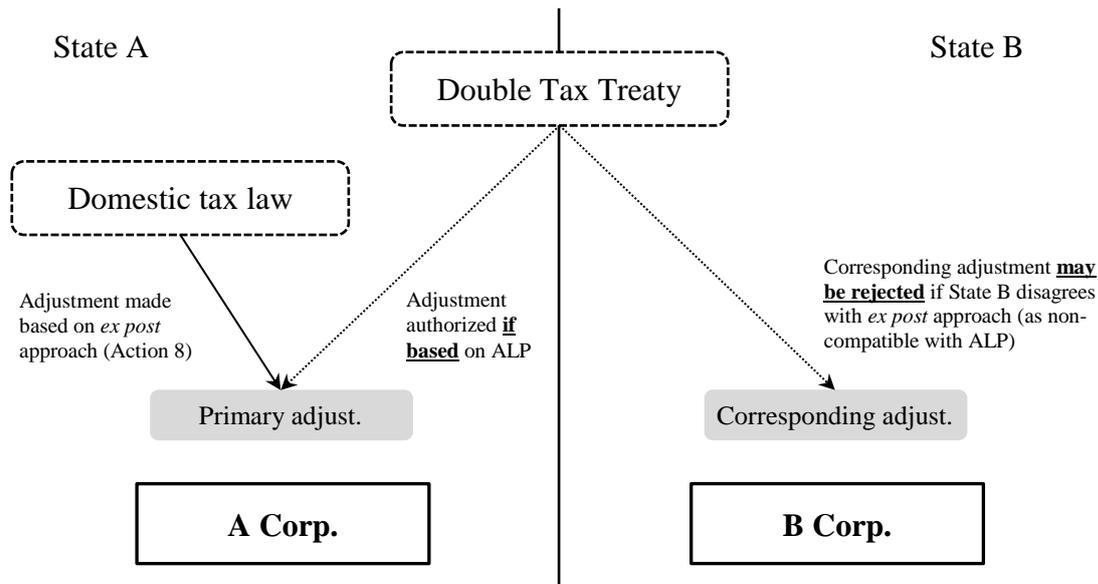
As an example, assume that associated enterprises agreed on the transfer price based on *ex ante* projections. At the time associated enterprises entered into the controlled transaction they reasonably believed that their forecasts were in line with what would have been projected between independent parties. Associated enterprises identified a number of factors that can contribute to the future outcomes of the transaction. In making projections they assigned different levels of probability to each factor. It appeared, subsequently, that certain factors had a greater effect on actual outcomes of the transaction which, however, was hardly predictable from the associated enterprises' standpoint.

Tax administration auditing the transaction came to a different conclusion relying on data obtained *ex post*. It took a position that the associated enterprises should have assigned higher levels of probability to the factors that eventually played out.

The abovementioned example resonates with the arguments presented in the chapter 4 as to the incompatibility of *ex ante* and *ex post* approaches. The result of such incompatibility is a deviation from the ALP in adjusting taxpayer's profits. Therefore, it will be no wonder that the tax administration in the second contracting state rejects the corresponding adjustment in relation to the primary – non-ALP based – adjustment. In essence, this situation is characterized as the economic double taxation – taxation of the same profit in both contracting states in the hands of two associated enterprises.

The proposed rules on treatment of HTVI transactions address the issue of information asymmetry. At the same time, they could create an instance of economic double taxation which Model Convention does not relieve. Under such circumstances application of the corresponding adjustment would be largely dependent on the other contracting state's position regarding *ex post* assessment. In particular, economic double taxation could be relieved if both contracting states share their views of the *ex post* approach, i.e. both states take a position that the Action 8 measure is in line with the ALP. But even in the latter case, the risk of economic double taxation will still persist. It is likely that the second contracting state will be willing to analyze circumstances of each primary adjustment made based on *ex post* outcomes to ensure that the ALP was complied with in the first contracting state.

Therefore, the author identifies the risk of economic double taxation as one of the major implications stemming from the *ex post* approach. It may be the result of the disagreement between two contracting states as to the compatibility of the new Action 8 measure with the ALP (an illustration of the disagreement between contracting states as to the transfer pricing adjustments is illustrated in the figure below).



Furthermore, looking at the very substance of the primary adjustment contemplated in Article 9(1), one may claim that it is not only the second contracting state which may reject the corresponding adjustment, but it is, first of all, the state of the primary adjustment which should refrain from rewriting taxpayer's accounts based on *ex post* outcomes.

According to Commentaries, Article 9(1) does not authorize rewriting of the taxpayer's accounts if the controlled transaction has 'taken place on normal open market commercial terms (on an arm's length basis).'¹⁵⁷ Kofler interprets Article 9(1) as prohibiting 'profit adjustments to any amount exceeding an arm's length profit.'¹⁵⁸ From this interpretation it may be concluded that if the *ex post* approach is found to be incompatible with the ALP, relevant contracting state does not have grounds to make the primary adjustment under Article 9(1).

In practical terms, the new measure creates unpredictability around transactions with HTVI affecting MNEs' tax positions and business structures. In view of the described risk associated enterprises may be discouraged to enter into transactions involving HTVI. This could affect, for instance, transfers of intangibles within MNE, restructuring of associated enterprises involving intangibles' transfers as well as planning of MNEs' future business models. It is likely, in light of the proposed measures, that some MNEs would reconsider their existing business models. For example, they may shift development of intangibles to tax-friendly jurisdictions (e.g. Patent Box jurisdictions) to avoid transfer pricing risks associated with future HTVI transfers. Alternatively, they may avoid transferring intangibles until they are completely developed and their revenue potential is more predictable.

Moreover, some MNEs may discard cross-border cooperation in development of intangibles. Avi-Yonah describes the latter concern in the following way: 'The inability to forecast the taxes on international ventures with reasonable certainty may discourage taxpayers from

¹⁵⁷ *ibid*, 183 para 2.

¹⁵⁸ Reimer (n 43), 603.

undertaking such ventures despite higher potential returns. Such an inability also has multibillion dollar implications on the government's ability to plan its revenues in advance.¹⁵⁹

5.2. Finding ways to avoid the risk of economic double taxation

In this section the author attempted to find possible ways of addressing the risk of economic double taxation associated with HTVI transactions. The discussion is primarily focused on finding solutions to ensure that transfer prices in controlled transactions are based on the ALP even though tax administrations may be entitled to apply the *ex post* approach following the implementation of Action 8.

5.2.1. Arranging for APA

The arm's length price for the transfer or the use of HTVI may be agreed on with the tax administration in advance. In this case taxpayer substantiates its *ex ante* projections so as to avoid the risk of *ex post* reassessment. This solution is rather an attempt to avoid application of the special measure since APA is regarded as one of the exemptions under which *ex post* approach is not applicable.¹⁶⁰ It should be noted, however, that in practice this solution may be a costly and time-consuming arrangement which makes it available not to all MNEs.

5.2.2. Preparing extensive *ex ante* pricing projections

Associated enterprises may prepare detailed documentation describing forecasts of outcomes of the HTVI transaction. All relevant assumptions and cash flow forecast should be carefully explained. Taxpayers should factor in all foreseeable events that can contribute to the success or failure of the transaction as well as associated risks (including levels of probability of their occurrence). As in the previous subsection, this arrangement corresponds with one of the exemptions contemplated in Action 8¹⁶¹ and is aimed at preventing tax administrations from using *ex post* approach.

5.2.3. Price adjustment mechanisms

Action 8, in addition to rules on HTVI, contains a set of rules dedicated to transactions involving 'intangibles for which valuation is highly uncertain at the time of the transaction.'¹⁶² These rules contemplate, among others, several mechanisms ensuring that uncertainty of pricing projections are aligned with actual outcomes of transactions. Such mechanisms include short-term agreements, price adjustment clauses, and payment structures involving contingent payments.¹⁶³

Associated enterprises could use these mechanisms in transactions involving HTVI to address mentioned earlier risk of economic double taxation because of differences between *ex ante*

¹⁵⁹ Avi-Yonah (n 31), 26.

¹⁶⁰ OECD Actions 8-10 (n 11), para 6.193.

¹⁶¹ *ibid*, para 6.193.

¹⁶² OECD Actions 8-10 (n 11), paras 6.181 - 6.185.

¹⁶³ *ibid*, paras 6.183.

projections and *ex post* outcomes. In essence, these mechanisms would ensure that even if projections deviate from actual results, the ultimate transfer price aligns with such actual results. For instance, the initial transfer price may be changed in accordance with the price adjustment clause or the new transfer price may be agreed upon in the course of entering into one of the short-term agreements.

Mentioned mechanisms, however, are not always acceptable in transactions between independent parties (as discussed in subsection 4.4.2 above). For this reason, the suggested solution may not be a universal recipe to ensure transfer prices are based on the ALP. Moreover, the author admits that this option does not resolve the main issue raised in this paper – ensuring application of the ALP while relying on the *ex post* approach. Rather, this solution facilitates taxpayers in adjusting transfer prices to actual outcomes of the transactions to avoid future controversies with tax administrations.

5.2.4. Conclusive remarks

The discussion above shows that the proposed *ex post* approach will increase compliance costs for taxpayers dealing with HTVI or discourage them from entering into HTVI transactions due to a high degree of uncertainty of transfer pricing outcomes. Moreover, based on the analysis in this paper, the author has failed to find a balanced solution for preserving the ALP in transfer pricing treatment of HTVI transactions and, at the same time, allowing tax administrations to use the *ex post* approach according to Action 8.

6. CONCLUSION

In this thesis the author has exposed issues which HTVI bring into the field of transfer pricing. The major one is the difficulty in applying the ALP to HTVI transactions. Similar transactions between independent parties could hardly be found in the open market which means essentially that there are no comparables to refer to in the transfer pricing analysis.

As a response to the phenomenon of HTVI, OECD has proposed new transfer pricing regulations within its Action 8 recommendations. The regulations are set out in the form of a revision to the TP Guidelines' chapter on intangible property. OECD has developed them with a view to ensure that transfer pricing outcomes of HTVI transactions are aligned with value creation. The regulations' main feature is a special tool made available to tax administrations – authorization to assess transfer prices based on *ex post* outcomes of HTVI transactions. The rationale behind this new measure is that tax authorities suffer from information asymmetry when assessing HTVI transactions and, as a result, may not reliably examine relevant transfer prices.

The OECD's efforts to resolve problems revolving around HTVI can only be welcomed. Both tax administrations and taxpayers experience unpredictability when it comes to HTVI transactions and they would eagerly adhere to a set of clear regulations to avoid future transfer pricing controversies. However, as the present discussion shows, in proposing the new approach OECD has departed from the ALP. It is fair to note that such deviation is not absolute and there is some room (at least theoretically) for the new approach to be in line

with the ALP. Nonetheless, possible outcomes stemming from Action 8 could hardly be viewed as ones initially intended under the BEPS project.

The ALP is an internationally recognized principle which underlies existing transfer pricing regulations. It is enshrined in OECD's authoritative sources, the majority of the world's tax treaties and domestic tax laws. The present analysis demonstrates that the ALP is associated with some flaws as it does not take into account synergetic nature of MNEs. Such flaws become especially vivid in controlled transactions involving HTVI. Nevertheless, the transfer pricing adjustments are so far premised on the application of the ALP (except for certain limited cases such as the 'commensurate with income approach' in the US). This principle also lays the ground for the relief from economic double taxation under tax treaties.

The author comes to a conclusion that implementing Action 8 recommendations into domestic transfer pricing regulations will lead to the deviation from the internationally recognized principle – the ALP – and, as a result, cause the risk of economic double taxation. Namely, if one of the contracting states makes a primary adjustment based on the *ex post* approach, the other contracting state may reject the corresponding adjustment arguing that it is not based on the ALP.

Present analysis proves to be unsuccessful in finding a solution, on the hand, to ensure application of the ALP and, on the other, to allow tax administrations to rely on *ex post* outcomes in tax audits. Taxpayers may consider arranging for APAs, preparing extensive *ex ante* pricing projections or relying on price adjustment mechanisms (e.g. payment structures involving contingent payments or price adjustment clauses). These solutions, however, are rather aimed at preventing tax administrations from using the *ex post* approach. They fail to resolve the main issue raised in this paper – ensuring application of the ALP while relying on the *ex post* approach.

OECD admits difficulties in the ALP-based transfer pricing treatment of transactions with intangibles (especially HTVI). However, it does not admit that the *ex-post* approach may deviate from the ALP and tries to squeeze this approach into the frame of Model Convention's Article 9. As some academics argue, the most appropriate solution for this conflicting situation is amending Article 9 so as to admit that transactions with HTVI fall outside of the ALP.

At the same time, the feasibility of such alternative approach should be taken into account. Implementing this solution would require revisions to existing tax treaties so as to reflect the non-ALP approach to transfer pricing treatment of HTVI transactions. Whether this is a realistic task is a rhetoric question. However, maybe it is the right time to start moving towards the new standards corresponding with current reality. As the BEPS project shows, OECD is very well positioned to start this movement.

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