A PROPOSED TREATMENT FOR H.T.V.I.

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****This article was written prior to the October 5, 2015 release of the B.E.P.S. report on hard to value intangibles. It remains a relevant discussion of the subject with the proviso that tax administrations may consider using actual outcomes (i.e., sales or profits) from intangible asset transactions in place of expected or forecasted outcomes when actual and forecasted outcomes differ and either (a) compensation for the asset or the right to use the intangible changes by more than 20% or (b) sales during the first five years of commercialization of the intangible asset vary by more than 20%. This is the most significant change from the June draft, and interestingly, weakly parallels, in part (b), the commensurate with income exception in Treas. Regs. §1.482-4(f)(ii)(B)(6).****

If you or your clients suffer from H.T.V.I., or "hard to value intangibles," news of a promising treatment has been announced by the O.E.C.D. Centre for Tax Policy and Administration.[1]

Back in the heady days of the emergence of Web 2.0, many young companies and partnerships inadvertently contracted H.T.V.I. in transactions involving the sale or cost-sharing of new technologies and other intangible assets whose future revenues and cash flows were necessarily difficult to forecast. More recently, H.T.V.I. has been singled out as being one of the leading causes of base erosion and profit shifting ("B.E.P.S."), the current affliction of the international tax system as identified by the O.E.C.D.

Many previously untreatable cases of H.T.V.I. have been hotly debated in the course of (i) transfer pricing audits, (ii) mutual agreement discussions between Competent Authorities, and (iii) litigation in courts. Often the arguments related to asset valuations and assumptions were relatively unsophisticated, resembling home remedies applied to cure a serious illness. Now that Web 2.0 has established itself in the business world, the use of hindsight has become popular among tax authorities looking for a rationale to challenge pricing. As a practical matter, tax authorities often do not have the same information as a company, owing simply to the lack of experience with the business. Hindsight, while logically inconsistent with a classic arm's length approach, diminishes the value of information asymmetry during the course of a tax examination.

The O.E.C.D.'s approach to the valuation of H.T.V.I. recommends that multinational companies look to independent transactions in order to find evidence to support the

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[1] See "Discussion Draft on Arm's Length Pricing of Intangibles When Valuation is Highly Uncertain at the Time of the Transaction and Special Considerations for Hard-to-Value Intangibles," supplemented by "Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports, OECD/G20 Base Erosion and Profit Shifting Project," O.E.C.D. Publishing, 2015.

treatment of uncertain future events. For example, a company may look to agreements that it has previously entered into or agreements between similarly situated independent parties.

In the event that independent parties to an agreement view the future as highly uncertain, related parties are encouraged to follow these examples and adopt similar terms used to manage the effects of uncertainty, such as agreements with a shorter term or those that include price adjustment clauses, milestone or contingency payments, or stepped royalty rate schedules. Some evidence from arm's length agreements of events that trigger contract renegotiation indicates that renegotiation is proper when it is clear that the initial agreement was entered into at a time that is characterized by uncertainty of success and value. This approach is suggested as a way to conform related-party negotiations with negotiations carried out wholly at arm's length, with respect to the terms of the agreement and future obligations of the contracting parties to revisit said terms. At an unsophisticated level, think of a professional athlete refusing to report to pre-season training camp as a tactic to renegotiate his contract.

Evidence of the form of independent agreements, as well as the ability to discern a foreseeable event from a truly unforeseeable event, are two things that become critically important in the O.E.C.D. approach. It follows that the difference between the expected profit from the exploitation of an intangible asset and the actual profit can differ at arm's length, provided there have been demonstrably unforeseeable events in the period following the intangible asset transaction.

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To become immunized against the future adverse effects of H.T.V.I., the O.E.C.D. proposes that taxpayers provide a full explanation of all forecast inputs and assumptions used at the time of the intangible asset transfer, as well as how the risks expected to be incurred by the contracting parties are incorporated into these forecasts. This explanation should include a comprehensive "consideration of reasonably foreseeable events." The second and final recommended step is to document differences between forecasted and actual outcomes in subsequent years, and to show that these differences are the result of developments that were unforeseeable at the time of the intangible asset transaction.

Though more burdensome, these recommendations reflect a good measure of common sense, especially if some reliable evidence of contractual terms agreed between independent parties can be found. Of some concern, however, are the examples of a natural disaster and a bankruptcy as unforeseeable events in the discussion draft. The list of surprises or unforeseeable events in business is considered by many to be longer than acts of god or business failures. One need only look at the long lists of risk factors found in S.E.C. filings to appreciate the diversity of events that a business might consider unforeseeable.

A recurring theme of the B.E.P.S. Project, as it relates to transfer pricing matters, is the availability of relevant and reliable data upon which to base comparability analysis and adjustments. The H.T.V.I. discussion draft reprises this theme, as the proposed procedures and tests depend critically on the presence and quality of information and contractual terms. As is noted by the O.E.C.D., this type of information is difficult to find. Though information exists, it must be recognized that much

of the building of the digital economy has been funded privately, making the terms of agreements that are relevant to modern businesses significantly harder to locate. While this constraint affects both companies and tax authorities, the approach proposed by the discussion draft places the initial burden of proof on the taxpayer. Availability of examples of intangible asset transactions and contractual terms at the time of a transaction, supplemented by examples found after the conclusion of the transaction, will become increasingly important to supporting valuation assumptions and documenting the entirety of the valuation process. Left unresolved is the relevance of the timing of the transfer pricing documentation due date compared with the transaction date when determining which data were available to the taxpayer under relevant country law.

Clearly the O.E.C.D. views opportunistic asset valuations as abusive. In view of this position, the consistency of the forecasting methods and assumptions employed by companies and their advisors across time and between transactions will become the subject of transfer pricing scrutiny. A company may be at risk of a transfer pricing adjustment if, for example, a tax authority obtains records of both (i) a valuation calculation prepared in respect of a Year 1 transaction of Intangible Asset Type A that assumes the intangible asset's economic life is X years in duration, and (ii) a buy-in payment valuation in respect of a Year 3 transaction of Intangible Asset Type A that assumes the intangible asset's economic life is Y years in duration. It will be ever more important to document the analytical process that is followed to determine the accuracy of assumptions[2] and the standard employed to identify and model uncertain events.

For some, the promise of a cure[3] offered by the O.E.C.D. approach will present an opportunity to vaccinate against certain strains of future transfer pricing uncertainty (once clinical trials are complete and legislative approvals have been granted, of course). Unfortunately for others, a tax authority may well administer the treatment involuntarily, at great expense, and without regard for possible side effects.

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[2] Assumptions that consist of statements that reference the analyst's or valuator's experience would arguably no longer be acceptable.

[3] The O.E.C.D. Committee for Fiscal Affairs has not reached a consensus on the definition of the cure for H.T.V.I.