Grant Thornton discussion draft response

BEPS Action 8: Hard-to-value Intangibles (HTVIs)

Grant Thornton International Ltd welcomes the opportunity to comment on the OECD public discussion draft entitled BEPS Action 8: Hard-to-value Intangibles (HTVIs), issued on 4 June 2015. We appreciate the work that the OECD has undertaken on the revised chapter VIII and would like to make the following comments on the public discussion draft.

In many ways how to deal with HTVIs is the critical issue for the BEPS project. We appreciate that the BEPS project is closing in on a deadline but we are disappointed that public comments have been invited within a 14 day deadline. Such a short comment period limits full reflection of the issues raised particularly given the views and proposals do not yet present a consensus view of the CFA or its subsidiary bodies.

There are some tangible assets which are also hard to value, and on grounds of consistency the principles in this discussion draft should also be applied in those circumstances. We would therefore support section D3 being retitled more generically 'hard to value assets'.

Proposed section D.3. Arm's length pricing when valuation is highly uncertain at the time of the transaction

Mechanisms adopted by independent enterprises to protect against the risks posed by the high uncertainty in valuing the intangibles that could be adopted by related entities

We observe that paragraph 1 of the discussion draft suggests the arms' length pricing should be resolved 'by reference to what independent enterprises would have done in comparable circumstances'.

The discussion draft indicates that independent enterprises might adopt shorter-term agreements, include price adjustment clauses in the terms of the agreement, or adopt a payment structure involving periodic milestone payments to protect against subsequent developments that might not be sufficiently predictable.

Comment: In our experience, HTVI are often created in the research or early development stage of new products or ventures. By their nature, and as alluded to in paragraph 10 of the draft, the derivation of future income from the HTVI can be highly uncertain and often requires considerable further expenditure (by way of further development and/or the commencement of sales and marketing activities) before the success, or otherwise, of the asset will be determined. Accordingly, the primary risk taker in a transaction for the transfer of a HTVI or rights in that HTVI is usually the entity providing the capital, the acquirer. Therefore, on an arm's length basis, once transferred, the transferor relinquishes the majority of the rights to future profits from the exploitation of the HTVI. Hence it is not always the case that uncertainties are dealt with via adjustment clauses or similar means. They are often dealt with as part of the valuation exercise to set the price and terms at the date of the transaction, often with the inclusion of a high discount for risk of failure.

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The suggestion in paragraph 2 and 3 of the draft that flat prices are paid only where outcomes are 'predictable' is not the case in many third party situations. Stepped royalty methodologies are often seen in licence agreements for intangibles between unrelated parties. Furthermore, it is not uncommon for contracts for the sale of businesses including intangible assets to include 'earn out' clauses or payment terms including contingent amounts that would become payable only on the achievement of specified milestones, usually in the form of profit thresholds. However, it should be acknowledged that these agreements represent the negotiated position of the value and basis for consideration between a willing buyer and willing seller at the time of the agreement and would not typically be renegotiated for ex-post information.

As outlined in paragraph 4 of the draft, we recognise that companies acting at arm's length may sometimes seek to renegotiate onerous agreements in accordance with contractual 'break' clauses. The example provided is where royalties under a product Intellectual property (IP) licence agreement are set at a level that does not enable the licensee to trade profitably. At this stage, the intangible asset subject to the agreement is unlikely to be classified as a HTVI as income streams should be reasonably certain. We consider arm's length behaviour in these circumstances would include a range of outcomes covering:

i. accept the royalty arrangement until the end of the term
ii. terminate the agreement and walk away
iii. renegotiate a royalty rate for future periods, but not for past years.

Hence any review should not allow or give credence to tax authorities re-assessing the arms' length nature of any earlier transaction relating to the intangible whilst it was classified as a HTVI. It is not appropriate to use ex-post information to reconsider and reset ex-antepricing decisions.

The principle of arm's length pricing works well in practice when there are comparable circumstances, including transactions in similar assets of a similar volume undertaken between independent willing parties. It is more difficult if not impossible where there is no established market of similar transactions, or the asset is close to being unique. In such circumstances it may be most efficient for the enterprise to engage an independent professional valuation expert. Section D3.1 should be explicit in this regard.

It is worth clarifying the meaning of comparable circumstances. This should include at least similar knowledge of the asset and the wider business sector; core businesses of the contracting parties are at similar stages of development; operating in similar business environments in the relevant economies; facing similar operating risks and with similar risk appetites.

Special considerations for HTVIs

The discussion draft suggests that there may be a need for special considerations to be adopted by tax authorities when dealing with the transfer of HTVIs. Such assets would include those where, at the time of their transfer between group companies: (i) no sufficiently reliable comparable data exists; and (ii) there is either a lack of reliable projections of future cash flows or income expected to be derived from the transferred asset, or the assumptions used in valuing the asset are highly subjective and therefore uncertain.

In this respect, the draft proposes that tax authorities may use ex post evidence about financial outcomes in years subsequent to the transfer to determine whether a price adjustment is necessary, and where changes from forecasts are not linked to identifiable external factors.

Comment: There will be challenges in determining when the arm's length principle will continue to apply and when the special considerations should be taken into account.

Additionally, the draft indicates that special considerations will not apply where tax authorities are able to 'reliably assess' the information available at the time of the transfer. It remains to be seen whether multiple tax authorities that review the same transactions will agree on whether information can be reliably assessed.

As noted above, in third party situations there is often high uncertainty. We are very concerned that tax administrations will seek to argue that:

i. either taxpayers had exploited asymmetry of information when the taxpayer did not know or could not reasonably have foreseen the outcomes
ii. taxpayer projections must be perfect in order to escape the use of hindsight.

There will be asymmetry of outcome as ex ante information is not perfect. It may be tempting for tax authorities to use ex post information when values go up but not when they go down.

Given that 'hope value' is not achieved in many third party deals but can be significantly exceeded in others (the 'blockbuster' intangible), this is a real and serious concern. By way of example, the London Financial Times of 16 June 2015 reported four experimental or development drugs sold by GSK to third parties which have subsequently significantly increased in value.

Accordingly, we are concerned with the implication of using hindsight. In the context of valuations in business acquisitions, we understand for example that the UK courts are unlikely to accept the application of hindsight. The UK courts have indicated that a valuation should be based on the facts and outlook at the valuation date and hindsight should not be used as a sense check of assumptions at the valuation date. Looking back and judging likely outcomes with the benefit of hindsight has the potential to misstate values at the time decisions were taken because hindsight could under/overestimate estimate perceived risks attached to the businesses/investments at that time.

This is on the basis that business management should be able to assess, with reasonable certainty, reasonably predictable events within a reasonable future time window but cannot have the necessary 'perfect' market information to make reliable valuation and pricing decisions beyond that time frame.

Accordingly, when assessing the arm's length pricing for a HTVI, tax authorities should not be allowed to apply ex post evidence about financial outcomes beyond a short time window. The onus in paragraph 14(2) is that the taxpayer should 'provide satisfactory evidence that any significant differences… could not have been anticipated at the time of the transaction'. We consider that if the taxpayer has provided details of its ex ante projections, risk assessment and its consideration of reasonably foreseeable events and risks as set out in paragraph 14(1), or has relied on an independent professional valuation, then the onus should be on the tax authority to demonstrate that these assumptions did not reflect the economic or commercial facts and circumstances at the time of the transaction. For this reason, we suggest the application of ex-post evidence by tax authorities (paragraph 12) should not be considered beyond a limited period, say, of 12 months from the date of the transaction.

We would welcome a recommendation from the OECD on a unilateral or bilateral advance clearance procedure for HTVI transactions. Such a clearance procedure could enable the ex-ante assumptions to be reviewed at or shortly after the date of the transaction and provide greater certainty for both taxpayers and tax authorities.

Use of ex post outcomes

D3.1 paragraph 11 says '…[verifying the arm's length basis on which pricing was determined] will prove difficult for a tax administration…until ex post outcomes are known'. Section D3.1 paragraphs 12-15 infer that using ex post outcomes is the only or preferred solution, because paragraph 14 describes exemptions when this approach will not apply.

Comment: As paragraph 13 says, this solution introduces additional judgement into an issue which is already subjective. Whether developments or events were or should have been foreseeable will likely be different when viewed from one perspective or another.

We do not believe that ex post factors should be used. However, if they are retained as an option in section D then section D3.1 should be rewritten to explain that ex post outcomes are the exception to be used only when all other avenues have been explored but have nevertheless not provided an appropriate solution. Other methods include those described in paragraph 14, and use of an independent professional valuer. It should also be explained that paragraph 14 is not an exhaustive list of acceptable methods for assessing the basis on which pricing was determined.

Intangibles falling within the category of HTVI

The draft proposes that the assets falling within the category of HTVI may exhibit one or more of the following features:

- Intangibles that are only partially developed at the time of the transfer
- intangibles that are not anticipated to be exploited commercially until several years following the transaction
- intangibles that separately are not HTVI but which are connected with the development or enhancement of other intangibles which fall within the category of HTVI
- intangibles that are anticipated to be exploited in a manner that is novel at the time of the transfer.

Comment: International Financial Reporting Standards (IFRS) address the recognition and valuation of assets for financial reporting purposes. Reference to IFRS in the draft will provide a more comprehensive explanation of the aforementioned features as well as additional examples. This would help reduce differences in tax and accounting treatments and prevent disputes and potential double taxation issues due to different tax authority interpretations.

Notion of 'significant difference'

The discussion draft states that the use of ex post evidence about the financial outcomes by tax administrations should ensure that the approach is applied in situations where the difference between ex post outcomes and ex ante projections is significant.

Comment: We consider that it is difficult to quantify 'significant' by reference to financial measures due to the extensive range of industries and economies in which HTVI are developed and traded. For example, a HTVI in the pharmaceutical industry is likely to have a very different risk and economic profile to one, say, in the industrial sector and thus the relative 'significance' is likely to be markedly different. Accordingly references to significance in paragraph 13 should be removed. Additionally, special considerations are only applied in circumstances where developments or events should have been foreseeable at the time of the transaction but not taken into account in the ex-ante assessment.

We would rather that the draft replace 'significance' with the concept of 'materiality'. Materiality is a widely understood concept, and would also promote greater harmony between tax and accounting treatments.

Additional points

In addition to our prior comments on the proposed guidance in the discussion draft, we comment below on the additional points raised.

Question 1

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

Comment: We support a process whereby agreement on tax treatment can be sought at or around the time of the transaction. This would eliminate the potential for ex post considerations inadvertently impairing the judgements of the contracting parties or the tax administrations.

Question 2

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

Comment: If the company uses an independent professional valuer to help it arrive at an ex-ante price then that should be an exemption to the approach described in section D3.1. Such an exemption could be phrased as follows: '…provides an ex ante independent professional valuer's report prepared to generally recognised valuation standards such as those published by the International Valuation Standards Council, together with instructions to the valuer'.

Question 3

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

Comment: We prefer the concept of materiality. However, if the principle of significant difference is retained, then the principle itself is sufficient, and should not be further defined.

Question 4

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

Comment: We would welcome the inclusion of more examples including several where the pricing would not be revisited.

If you would like to discuss any of these points in more detail then please contact:

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