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HARD-TO-VALUE INTANGIBLES

How to manage them in a BEPS world?

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PRINCIPAL ABBREVIATIONS

ALP	Arm's Length Principle
APA	Advance Pricing Arrangement
BEPS	Base Erosion and Profit Shifting
CCA	Cost contribution arrangement
CJEU	Court of Justice of the European Union
CSA	Cost sharing arrangement
CWI standard	Commensurate-with-income standard
EC	European Commission
HTVI	Hard-to-value intangibles
MNE	Multinational Enterprise
OECD	Organisation for Economic Co-operation and Development
TPG	Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations

INTRODUCTION

Multinational enterprises (MNEs) are under scrutiny for tax evasion practices, prompting political pressure and a call from the public to bring such conduct to a halt. In recent years, media and society have paid special attention to tax avoidance by MNEs by exploiting loopholes in tax legislation. Scandals like Swissleaks, Luxleaks, Panama Papers and most recently the Paradise Papers have received extensive media coverage and political attention. The abuse of loopholes in tax legislations is imputed to MNEs. Likewise, several governments are accused of unjustly awarding selective fiscal advantages. In the aftermath of the media exposure, the European Commission (EC) investigated and condemned the Belgian system of Excess Profit Rulings[1].

In response to the reports on tax dodging by MNEs, the Organisation for Economic Co-operation and Development (OECD) and G20 countries launched an initiative to combat base erosion and profit shifting (BEPS)[2]. This term captures the phenomenon whereby MNEs artificially shift taxable income to lower taxed jurisdictions. Based on the available data, the OECD is not able to determine how much BEPS occurs in practice, other than that circumstantial evidence indicates that BEPS behaviours are widespread[3].

The transfer of assets, both tangible and intangible, and services within a corporate group plays an important role in BEPS behaviour. According to internationally agreed standards formalised by the OECD, intra-group transactions should be priced at arm's length. The transfer price should be equal to the one that would be agreed between independent parties. By applying transfer prices that deviate from the market pricing, value and the accompanying taxable income can be shifted to fiscally more attractive jurisdictions.

[1] Commission decision (EU) 2016/1699 of 11 January 2016 on the excess profit exemption State aid scheme SA.37667 (2015/C) (ex 2015/NN) implemented by Belgium, *OJ* 27 September 2016, L260, 61-103.
[2] OECD, *Addressing Base Erosion and Profit Shifting*, Paris, OECD Publishing, 2013, 87 p. and DOI: 10.1787/9789264192744-en.
[3] *Ibid*., 15.

Intangibles are specifically vulnerable for abuse in shifting profits between associated enterprises, in large part because of their high mobility. Their value is often tied to unique characteristics and therefore more difficult to value objectively. Companies can achieve a lower effective tax rate when they are active in industries where value is heavily driven by intangible property. Effective tax rates of selected US companies illustrate this concept.

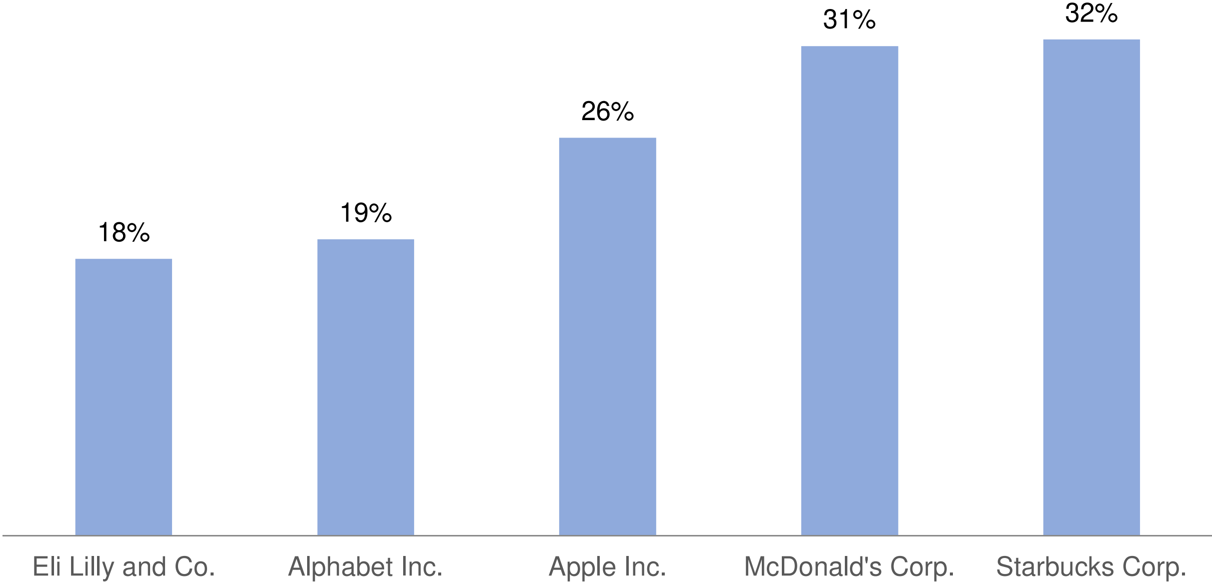

Figure 1: Effective tax rates (3-year weighted average)[4]

For the sampled companies, the pharmaceutical and IT MNEs exhibit a lower effective tax rate than the companies with physical sales activities. This does not imply an unauthorised or dubious BEPS behaviour. For example, several countries have implemented tax regimes such as IP-boxes to attract the development of intangible properties by offering a preferential tax treatment[5]. The US Tax Cuts and Jobs Act enables the taxation of the value of offshore intangible property of US MNEs by introducing two new concepts, the Global Intangible Low-Taxed Income (GILTI)[6] and the Base Erosion and Anti-abuse Tax (BEAT)[7].

[4] ALPHABET INC., “Form 10-K”, 2017, www.sec.gov/edgar, 38, 49 and 79-80; APPLE INC., “Form 10-K”, 2018, www.sec.gov/edgar, 28 and 39; ELI LILLY AND COMPANY, “Form 10-K”, 2018, www.sec.gov/edgar, 29, 53 and 84; MCDONALD’S CORPORATION, “Form 10-K”, 2018, www.sec.gov/edgar, 24 and 45; STARBUCKS CORPORATION, “Form 10-K”, 2018, www.sec.gov/edgar, 26 and 46. One-time impacts of the US Tax Cuts and Jobs Act were excluded.

[5] See CENTRE FOR EUROPEAN ECONOMIC RESEARCH (ZEW) GMBH, *The Impact of Tax Planning on Forward-Looking Effective Tax Rates*, Luxembourg, Publications Office of the European Union, 2016, 21-22 and DOI: 10.2778/584818. These regimes are also subject of review under BEPS. See OECD, *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance, Action 5 - 2015 Final Report*, Paris, OECD Publishing, 2015, 24-36 and DOI: 10.1787/9789264241190-en.

[6] An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018, Pub. L. 115-97, *Stat.* 22 December 2017, 2054, § 14201-14202.

The OECD identified fifteen actions to enable governments to fight BEPS[8]. The aim of Action 8 is to ensure that the outcome of transfer pricing of intangibles is in line with value creation[9]. Special attention is given to hard-to-value intangibles (HTVI). These intangibles exhibit many aspects of uncertainty with regards to the future benefits that can arise from the commercialisation. When HTVI are transferred between associated enterprises, the transfer price will have to incorporate forecasts and projections that may differ significantly from the actual realisation. The information asymmetry between the taxpayer and the tax authorities complicates the assessment by the latter whether the transaction was priced adequately[10]. During tax audits taxpayers can misrepresent or withhold information that was available to them at the time of the transfer.

The OECD is finalising its guidance on how tax authorities can address the information asymmetry in dealing with HTVI. The guidance seeks to empower tax administration to use the actual profits realised by the HTVI as an indication to evaluate the transfer price set at the outset. Price adjustments could be imposed, deviating from the pricing structure as set up by the taxpayer. Amidst all ongoing changes related to BEPS, tax authorities will have to decide if and how they will implement the guidance on HTVI. Taxpayers will need to take potential changes in the approach of future tax audits into account for their current intercompany transactions.

This dissertation studies how tax authorities and taxpayers can manage HTVI under the new guidance. The thesis will focus on the application of the OECD guidelines on HTVI as a distinct part of Action 8 of the BEPS initiative, covering the assessment of transfer pricing of HTVI. The remainder of the guidelines on intangibles and related initiatives, concerning amongst others cost contribution arrangements, are not studied in depth. The study seeks to identify obstacles to the implementation of the guidelines on HTVI in a global setting. To this end, the OECD guidance on HTVI is examined in relation to established principles and legislations on a national, supranational and international level. It is not the intent of the thesis to phrase recommendations to the OECD for changes to the guidelines.

The thesis will research the following aspects of the HTVI guidance.

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[7] *Ibid.*, § 14401.

[8] OECD, *Action Plan on Base Erosion and Profit Shifting*, Paris, OECD Publishing, 2013, 40 p. and DOI: 10.1787/9789264202719-en.

[9] *Ibid.*, 20.

[10] OECD, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports*, Paris, OECD Publishing, 2015, 110, no. 6.191 and DOI: 10.1787/9789264241244-en.

i. The approach on HTVI is compared to the arm's length principle (ALP). This internationally agreed standard is the foundation of the transfer pricing framework of the OECD. The compatibility of the guidance with the ALP is evaluated by comparing the recommendations with external arrangements between independent parties. The economic and legal reality of HTVI in arrangements between independent parties is examined against the proposed guidance. This assessment determines to which extent tax authorities can apply the guidance to remain consistent with the ALP.
ii. The thesis further examines how the guidance can be reconciled with the national legal system in Belgium, including laws and regulations, and jurisprudence. Impediments for the implementation of the guidance are highlighted.
iii. On the supranational level, the OECD guidance is tested against case law of the Court of Justice of the European Union. Additionally, the impact of the recent investigations by the EC on the OECD guidance is assessed.
iv. Lastly, the OECD guidance on HTVI is compared to international examples where similar legislations have been implemented, notably the commensurate-with-income (CWI) standard in the United States. This comparison highlights potential pitfalls and lessons learned from the foreign jurisdictions.

OECD GUIDANCE

Tax optimisation by multinational enterprises (MNEs) revolves around the reduction of the taxable base. Artificially shifting profits to jurisdictions with a lower effective tax rate is considered a major source of such base erosion. After substantial media coverage, tax dodging by MNEs was put on the political agenda of G20 and several individual countries[11]. It was recognised that national and international rules regarding taxation and transfer pricing were no longer up to date with a highly globalised economy[12]. The OECD created a framework to tackle the challenges around base erosion and profit shifting (BEPS) to allow for a uniform international approach.

Arm's length principle

OECD member countries have agreed that all transfer pricing should be based on the arm's length principle (ALP)[13]. When associated enterprises engage in transactions, conditions under which they transact should mimic those that would be agreed between independent parties. This principle is enforced in international relations via Article 9 "Associated enterprises" of the OECD's Model Tax Convention on Income and Capital (model convention)[14]. The article allows tax authorities to make adjustments to the taxable base of an enterprise in one Contracting State, if the taxable profits are understated or overstated as a result of transactions with associated enterprises resident in the other Contracting State under terms that are not market-conform. The OECD has issued Transfer Pricing Guidelines for

[11] OECD, *Addressing Base Erosion and Profit Shifting*, Paris, OECD Publishing, 2013, 13-14 and DOI: 10.1787/9789264192744-en.
[12] *Ibid.*, 5.
[13] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, Paris, OECD Publishing, 2017, 33, no. 1.1 and DOI: 10.1787/tpg-2017-en (hereafter: OECD, *TPG 2017*).
[14] OECD, *Model Tax Convention on Income and on Capital: Condensed Version 2017*, Paris, OECD Publishing, 2017, 226, no. 1 and DOI: 10.1787/mtc_cond-2017-en.

Multinational Enterprises and Tax Administrations[15] (TPG) to clarify methods to evaluate whether conditions are at arm's length.

The aim of applying the ALP is to level the playing field for associated enterprises and independent undertakings[16]. If associated enterprises enter into transactions under conditions that are similar to those between independent enterprises in comparable circumstances in the open market, the resulting tax treatment will be more equal. Tax advantages or disadvantages will be limited and thus not distort the economics of international competition.

Hard-to-value intangibles

Amongst the 15 actions that were identified in the Action Plan on the prevention of BEPS, Actions 8, 9 and 10 were targeted to ensure transfer pricing outcomes are in line with value creation. Action 8 contains the development of rules to avoid BEPS specifically by moving intangibles within a multinational group[17]. The final report on Action 8-10 details the measures to be taken, including supplemental guidance to determine arm's length conditions for hard-to-value intangibles (HTVI)[18]. The recommendations set forth in the final report have been integrated in the 2017 update of the TPG.

Definitions

Intangibles are defined in the TPG as "something 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"[19]. Examples include patents, know-how and trademarks.

HTVI refer to intangibles for which, at the time of the intra-group transfer, there are no reliable comparables. Additionally, projections of cash flow, future income or assumptions used to value the intangibles are highly uncertain. The transactions involving HTVI can be characterised by one or more of the following attributes[20].

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[15] Latest version: OECD, *TPG 2017*.
[16] *Ibid.*, 36, no. 1.8.
[17] OECD, *Action Plan on Base Erosion and Profit Shifting*, Paris, OECD Publishing, 2013, 20 and DOI: 10.1787/9789264202719-en.
[18] OECD, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports*, Paris, OECD Publishing, 2015, 109-112, no. 6.186-6.195 and DOI: 10.1787/9789264241244-en.
[19] OECD, *TPG 2017*, 249, no. 6.6.
[20] *Ibid.*, 309-310, no. 6.189-6.190.

- The intangibles are transferred before being fully developed.
- Commercialisation of the intangible is not expected until several years after the transfer.
- The intangible is not categorised under HTVI in itself, but it is essential to the development or enhancement of intangibles that do fulfil the definition of HTVI.
- The intangibles are intended to be exploited in a manner that is novel at the time of transfer.

Joint development

In a cost contribution arrangement (CCA), companies agree to share the contributions to the development, production or acquisition of tangible or intangible assets[21]. Participants to a development CCA contribute proportionately to their share in the expected benefits. Such contributions include development activities as well as pre-existing intangibles. The intangibles developed in or contributed to a CCA or similar arrangements can qualify as HTVI.

The value of current contributions is based on the value of the function performed. Pre-existing assets that are contributed are valued according to the ALP. Balancing payments can be made between participants to ensure the overall contribution of each participant is proportionate to the expected benefits to be received. Late participants entering a CCA can make a buy-in payment to compensate existing participants for past contributions. A CCA should include periodic revisions of the expected benefits for each participant to adjust future contributions accordingly.

Market transactions

Transactions in the open market can involve HTVI. Large enterprises have an incentive to acquire technology through the acquisition of smaller undertakings, rather than performing competing R&D activities[22]. Alphabet Inc., parent company of online search engine Google, spent about $1 billion on acquisitions in 2016. Of that sum, 26% was attributed to intangibles and 65% to goodwill[23]. In 2017, Alphabet Inc. completed acquisitions for $322 million, of which 36% was paid for intangibles and 69% for goodwill[24].

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[21] *Ibid.*, 345-364.

[22] See G. M. PHILLIPS and A. ZHDANOV, "R&D and the Incentives from Merger and Acquisition Activity", *Rev. Financial Stud.* 2013, 34-78.

[23] ALPHABET INC., "Form 10-K", 2017, www.sec.gov/edgar, 65.

[24] ALPHABET INC., "Form 10-K", 2018, www.sec.gov/edgar, 70.

Some companies decide to structurally engage in the acquisition of HTVI. Pharmaceutical multinational Eli Lilly and Company (Lilly) invests, via its joint venture TVM Life Science Ventures VII (TVM JV) with venture capitalist partners, into promising single asset start-ups[25]. Through its Chorus division, which uses a specialised model, Lilly supports the development of the early-stage drugs throughout the subsequent phases up to clinical proof of concept[26]. Contributions, risks and rewards of the uncertain drug development process are shared between Lilly and the start-up. The start-up, Lilly and the venture capital joint venture partners aim to capture their share of the value created in the structure.

Each of the parties contributes intangibles to the venture. Lilly brings industry knowledge and the unique Chorus model to the table. The venture capitalists have specialised knowledge about the identification and acquisition of target companies. The start-ups have a possibly ground-breaking intangible property. While the last is the most obvious HTVI, other intangibles involved by other parties may fit the definition as well.

Guidance

The aim of the new approach set forth by the OECD is to address the information asymmetry between taxpayers and tax administrations on the valuation of HTVI[27]. Transfer prices are determined by the taxpayer based on information available at the time of the transfer. Factors influencing the appropriate transfer pricing are often industry or company specific, or may be very technical. During tax audits, the taxpayer chooses which information he presents at his own discretion. Differences between the ex ante valuation of the transferred intangible and the ex post value thereof would be attributed by the taxpayer to more favourable developments than anticipated. Often cases, the tax administration will have insufficient information available to determine whether the transfer pricing was at arm's length or whether subsequent developments could have reasonably been foreseen.

To address this information asymmetry, the OECD puts forward an approach specific to HTVI in the final report[28]. The ex post outcome can be used as presumptive evidence to evaluate the appropriateness of the ex ante transfer pricing. The actual profit levels

[25] TVM CAPITAL LIFE SCIENCE, "About us", www.tvm-lifescience.com/about-us/ (consultation 17 December 2017).
[26] See P. K. OWENS, E. RADDAD, J. W. MILLER, J. R. STILLE, K. G. OLOVICH, N. V. SMITH, R. S. JONES and J. C. SCHERER, "A decade of innovation in pharmaceutical R&D: the Chorus model", *Nature* 2014, 17-28.
[27] OECD, *TPG 2017*, 309, no. 6.191.
[28] *Ibid.*, 309-311, no. 6.188 and 6.192.

attributable to the HTVI can be used by the tax administration to assess whether at the time of the transaction uncertainties existed, whether the taxpayer took reasonably foreseeable developments or events into account, and whether the information used to determine the transfer price for the transfer is reliable. This evidence is rebuttable by the taxpayer. This approach puts significantly more burden on the taxpayer to prove consistency with the ALP than was the case in previous TPGs. The OECD specifies that the approach should be limited to cases where the tax authorities otherwise cannot evaluate the reliability of the information on which the ex ante arrangements have been based.

In its guidance to use the ex post outcome as presumptive evidence, the OECD implicitly assumes that realised benefits can easily be attributed to specific intangibles. In practice this may prove to be more difficult. When multiple intangibles are combined, the allocation of the value contribution to each intangible may be subject to debate. Likewise, the value attributable to ongoing development may be hard to separate from the base value of a transferred HTVI.

Android value

Google Inc.[29] (Google) has acquired several companies to strengthen its position in the mobile market. Mobile advertising platform AdMob, Inc. was acquired in 2010 for $681 million[30]. Although the split is not published in the annual report, revenues are derived directly from the product.

AdMob is not listed under the company's core products, unlike open-source mobile operating system (OS) Android[31]. Google has acquired and enhanced Android, while there is no licensing fee charged to mobile device makers for its use. Although there are no revenues directly linked to Android, the OS supports Google's overall business model to sustain and increase its advertisement revenues[32]. Several aspects of the profitability are likely to be influenced by the operating system development. The direct traffic acquisition costs (TAC)[33] will likely be lowered. The success of Android can improve the negotiating position with

[29] In September 2017, Google Inc. changed its legal form to become Google LLC, as part of the restructuring under the holding company Alphabet Inc.

[30] GOOGLE INC., "Form 10-K", 2011, www.sec.gov/edgar, 69.

[31] ALPHABET INC., "Form 10-K", 2018, www.sec.gov/edgar, 3.

[32] See G. M. PHILLIPS and A. ZHDANOV, "R&D and the Incentives from Merger and Acquisition Activity", *Rev. Financial Stud.* 2013, (34) 39.

[33] TAC are payments made to display advertisements on third-party websites and via third-party browsers, operating systems and so forth.

other alternative providers, such as iPhone manufacturer Apple Inc., and may have kept competitors like Microsoft Corp. from conquering market share with phones featuring Bing as the default search engine.

The success of Android supports the value of other Google core products, not in the least mobile app store Google Play. It is hard to quantify how much of the profits are attributable to Android, compared to the intangible property directly related to the development of Google Play, Search, AdMob and other products.

The arrangements governing a controlled transfer can be adjusted by tax authorities based on the actual financial results, including the introduction of any contingent payments. The TPG mention such contingent payments can be introduced if those would be agreed between independent enterprises[34]. The draft implementation guidance states that tax authorities can include contingent payments and price adjustment clauses, irrespective of the payment profiles governing the intercompany transaction[35].

Overall, the approach on HTVI does not apply if any of four conditions is met.

i. The taxpayer provides details on the ex ante forecasts, including an adequate reflection of risks and foreseeable events. He further provides evidence that any significant deviations from the projections are due to unforeseeable events or the playing out of risks that were duly taken into account.
ii. The transactions are covered by a bilateral or multilateral Advance Pricing Arrangement (APA)[36].
iii. Any adjustments based on the ex post outcome would not alter the transfer price by more than 20%.
iv. A commercialisation period of five years has elapsed since the HTVI first generated revenues from third parties. For that period, no significant differences between the projections and the actual outcomes, exceeding 20% of projections, have arisen.

Previous versions of the TPG included some limited guidance on HTVI, without using the term as such[37]. These previous versions mention an approach and examples for situations

[34] OECD, *TPG 2017*, 311, no. 6.192.
[35] OECD, "The Approach To Hard-To-Value Intangibles: Implementation Guidance For Tax Administrations", 2017, www.oecd.org/ctp/transfer-pricing/BEPS-implementation-guidance-on-hard-to-value-intangibles-discussion-draft.pdf, 4, no. 13.
[36] Presumably, the OECD expects tax authorities to respect their unilateral APAs. The reference to bilateral and multilateral APAs has likely been inserted to ensure tax authorities are not bound by APAs awarded by their foreign counterparts.

where the "valuation is highly uncertain at the time of transaction". The former guidelines provide an overview of potential considerations the tax authorities can have. They list several angles the tax administration can inquire to determine whether the transaction is priced at arm's length by identifying what independent companies would have agreed. Subsequent developments could at most prompt tax authorities to investigate what would have been agreed in an uncontrolled transaction. It was up to the tax administration to evaluate whether independent enterprises would have included provisions to protect against the uncertainties included in the projections[38].

Valuation and pricing

Transfer pricing is based on the valuation of the underlying asset. When comparable uncontrolled transactions are not available, the taxpayer will have to value the object of the transaction. This value should be reflected in the transfer pricing agreed between associated enterprises, as it is expected that independent undertakings would transact close to such economic value.

Valuation

The value and the corresponding valuation method of an intangible are dependent on several factors, like complexity and uniqueness. Broadly, three valuation approaches can be distinguished: cost-based, market and income approach[39].

Under the cost-based approach, the value of an asset is measured by the historical or replacement cost. The transfer price is based on the actual costs incurred to produce or develop the product, or the hypothetical cost to replace the property. This approach is suitable for low-complexity assets, e.g. commodities, inventory or licenses. It will not be an appropriate measure for the value of HTVI.

The market approach will determine the value by comparing to market prices. Techniques to determine the value of an intangible property include the relief-from-royalty method and the premium profit method. The former determines the value of an intangible by benchmarking

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[37] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010*, Paris, OECD Publishing, 2010, 201-203, no. 6.28-6.35 and 365-368, no. 1-10 and DOI: 10.1787/tpg-2010-en.
[38] *Ibid.*, 202, no. 6.33.
[39] DELOITTE, *Study on the application of economic valuation techniques for determining transfer prices of cross border transactions between members of multinational enterprise groups in the EU*, 2016, European Union, DOI: 10.2778/478527, 62-67 and 176-186; See also A. DAMODARAN, "Dealing with Intangibles: Valuing Brand Names, Flexibility and Patents", 2007, DOI: 10.2139/ssrn.1374562, 9-21.

the royalty that should have to be paid to acquire the rights to a similar intangible. The latter determines the value of the business with and without the intangible, attributing the delta to the value of the intangible. Market data will by definition not be available for HTVI. This approach will consequently not be applicable.

The net present value (NPV)[40] of future benefits is the basis for valuation under the income approach. Future cash flows attributable to the intangible property are discounted to their present value[41]. This approach can assign a value to HTVI, albeit inexact due to the uncertainty concerning future benefits. Based on this valuation, a suitable royalty, lump sum or combination can be derived.

In the valuation of HTVI, several elements may be highly uncertain. Sales figures may be hard to forecast. The revenues and useful life of the intangible may be subject to reactions by competitors. HTVI may not even make it to market if they prove to be worthless after further development, or their commercialisation is deemed to be uneconomic at a later stage. Costs for further development and ongoing maintenance may be equally prone to uncertainty.

CoLucid HTVI valuation

The acquisition of CoLucid Pharmaceuticals, Inc. (CoLucid) by Lilly illustrates how the value of HTVI can evolve unexpectedly. CoLucid was founded in 2005, when it licensed the migraine drug molecule lasmiditan from Lilly. This molecule remained virtually the only asset of the company, until the acquisition by Lilly in January 2017[42]. CoLucid issued shares to Lilly at the start of the license agreement[43] and TVM JV held shares in CoLucid from 2015 until Lilly acquired the company[44]. Throughout the entire time between the IPO and the acquisition by Lilly, lasmiditan was a Phase III molecule[45]. According to the U.S. Food and Drug Administration (FDA), only 25%-30% of the drugs in this phase move to the next. It

[40] The NPV represents the amount of cash that an investor is willing to pay today to receive the uncertain pay-out in the future. Today's value of future cash flows is less than its sum, due to the risk and time value of money.
[41] For a more elaborate discussion on discounted cash flows, see e.g. J. R. HITCHNER, *Financial valuation: applications and models*, Hoboken, N.J., Wiley, 2003, 101-111.
[42] ELI LILLY AND COMPANY, "Form 10-K", 2018, www.sec.gov/edgar, 65.
[43] COLUCID PHARMACEUTICALS, INC., "Form 10-K", 2016, www.sec.gov/edgar, 52.
[44] TVM CAPITAL LIFE SCIENCE, "CoLucid Pharmaceuticals", www.tvm-lifescience.com/portfolio/colucid-pharmaceuticals/ (consultation 12 January 2018); COLUCID PHARMACEUTICALS, INC., "Form 424B4 – Prospectus", 2015, www.sec.gov/edgar, 142.
[45] Before FDA approval, clinical trials will have to successfully complete four phases. U.S. FOOD AND DRUG ADMINISTRATION (FDA), "Step 3: Clinical Research", www.fda.gov/ForPatients/Approvals/Drugs/ucm405622.htm (consultation on 10 January 2018).

was uncertain whether and when the drug could be marketed, even still at the time when Lilly acquired CoLucid.

The implied value of the HTVI varied significantly during the period[46]. CoLucid's IPO in May 2015 for $10 per share valued the intangible at $76 million. Lilly acquired CoLucid for $46.5 per share, valuing the intangible at $858 million[47]. The valuation of the HTVI increased by more than ten times the original value in less than two years. In the interim, the value has fluctuated, even becoming negative at the end of the third quarter in 2015[48].

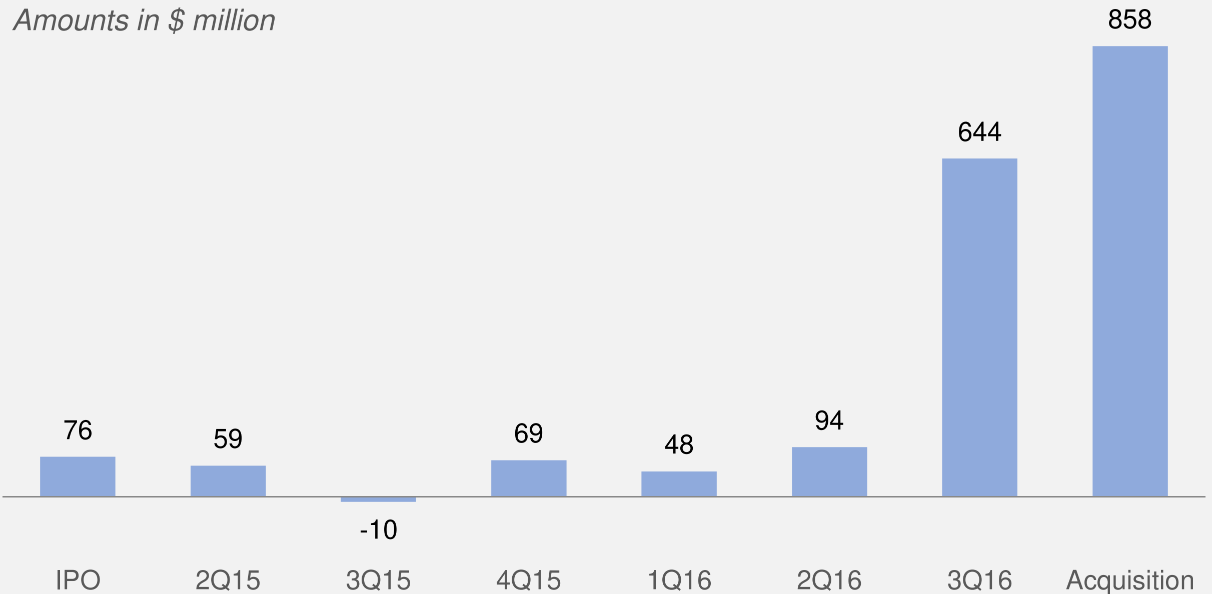

Figure 2: Implied value lasmiditan (CoLucid HTVI)

Pricing

The OECD generally distinguishes five transfer pricing methods, categorised as three "traditional transaction methods" and two "transactional profit methods"[49]. The traditional transaction methods include three methods:

i. the comparable uncontrolled price (CUP) method;

[46] The implied value is calculated by deducting the net assets, as reported in 10-Q and 10-K filings, from the market capitalisation. The market capitalisation of a company equals the share price multiplied by the number of shares outstanding. The net assets were predominantly cash and marketable securities. Their market value is therefore presumably close to book value. The result reflects the value of the intangible lasmiditan, excluding any contingent payments that are due to the licensor. See www.investing.com/equities/colucid-pharmaceuticals-chart (consultation 11 January 2018) for historical share prices. See CoLucid's 10-Q and 10-K filings via www.sec.gov/edgar for shares outstanding, IPO details and balance sheets.

[47] ELI LILLY AND COMPANY, "Form 10-K", 2018, www.sec.gov/edgar, 65.

[48] The negative valuation for the HTVI can for example be due to shareholders not knowing the exact cash balance of the company, or future commitments outweighing the value (if any) of the intangible.

[49] OECD, *TPG 2017*, 97-145, no. 2.1- 2.155.

ii. the resale price method; and
iii. the cost plus method.

The transactional profit methods are

iv. the transactional net margin method (TNMM); and
v. the transactional profit split method.

The traditional transaction methods are tied directly to the individual transactions, whereas the transactional profit methods refer to methods that take the eventual profit for the contracting parties into account. The former generally enjoy the preference over the latter.

The CUP method compares the price of a comparable transaction between independent parties with the price applied in dealings between associated enterprises. Adjustments can be made if the internal asset displays properties which deviate from comparable external items and which have a material impact on price. This method has preference over all others. Due to the unique character of many intangibles, it will often not be applicable in internal transactions of intangibles. This would correspond to a market approach for valuation. The definition of HTVI excludes those intangibles for which this method could be applied.

The resale price method attributes a reasonable gross margin to be applied to the functions exercised by the reseller. This method is targeted for marketing activities. A market-conform resale margin is applied to the price at which products are sold to an independent party, to derive the applicable intercompany price.

An appropriate mark-up on costs incurred is the basis of the cost plus method. If a low-complexity intangible is used in toll processing, this could be the most suitable method to determine the arm's length transfer pricing. The cost plus method corresponds to a cost-based valuation approach.

The transactional profit methods are akin to the income approach under the valuation. The TNMM determines the net profit that should be retained by the transferee, taking overhead and operating costs into account that are not directly linked to the sale or manufacturing of the products.

The only two-sided method is the transactional profit split method. The overall profit derived from a transaction is divided over the parties involved. When both parties involved make unique contributions, such as intangibles, this method is found to be the most applicable.

Determining the suitable division requires taking into account the functions performed, risks assumed and assets used by each party[50].

Specifically for intangibles, the transactional profit split method is, together with the CUP method, preferred over other methods[51]. Since comparables are by definition not available for HTVI, the transactional profit split method is the preferential method to determine the transfer price.

Reconciling HTVI and the ALP

The TPG explicitly mention that the approach to deal with HTVI is consistent with the ALP[52], where the Action Plan still mentioned that special measures on intangibles could be "within or beyond the ALP"[53]. Ex post results should only be taken into account if that is necessary to assess the appropriateness of the transfer pricing[54]. The OECD does not clarify why, while the use of posterior information is considered to be in line with the ALP, the guidelines are limited to cases where the tax authorities are otherwise not able to confirm the reliability of the ex ante information.

The transfer price analysis for an arm's length remuneration for intangibles starts with legal ownership[55]. However, legal ownership in itself is insufficient to be entitled to any returns of the intangible. The arm's length compensation for each member of the group is driven by the assets used, functions performed and risks assumed with respect to the development, enhancement, maintenance, protection and exploitation of such intangible[56]. The remuneration that each member of the corporate group receives, would consequently be in line with its contribution to the value created.

Differences between anticipated and actual profitability

Differences between the appropriately estimated profitability and the actual outcome should be allocated over the group members according to the risks they have assumed[57]. In other words, group members should be rewarded to the extent they have made economically

[50] The specific guidance for the transactional profit split is being revisited as part of BEPS Action 10. *Ibid.*, 133.
[51] *Ibid.*, 295, no. 6.145.
[52] *Ibid.*, 309, no. 6.188.
[53] OECD, *Action Plan on Base Erosion and Profit Shifting*, Paris, OECD Publishing, 2013, 20 and DOI: 10.1787/9789264202719-en.
[54] OECD, *TPG 2017*, 310-311, no. 6.192.
[55] *Ibid.*, 260, no. 6.35.
[56] *Ibid.*, 263, no. 6.45.
[57] *Ibid.*, 272, no. 6.69.

relevant contributions to the value of the intangible. If a profit sharing element has been agreed, the delta between forecasted and actual profits can also be attributable in part to group members who have provided support to control risks without assuming risks, or who have performed a function that has contributed significantly to the value of the intangible.

The transactional profit split method is the favoured method to determine the transfer price for HTVI. The discussion draft on the method allows for a split of either actual or anticipated profits, based on the specific circumstances of the transfer[58]. Especially when a split of anticipated earnings is selected, a large deviation between the anticipated and the actual profit derived for an intangible can significantly skew the division of profits away from the initially envisioned balance.

Even if the upfront valuation would include possible events with the appropriate probabilities, the ex post outcome reflects only one possibility. The taxpayer can rebut the presumption based on that outcome by demonstrating the deviation between forecast and actual is driven by the risks duly taken into account. It will be hard for the taxpayer to demonstrate the probability ex ante assigned to the realised events were accurate[59].

The OECD stresses the approach should be differentiated from using hindsight to determine the transfer pricing without considering the information available at the time of determination of the transfer pricing. Only information that could or reasonably should have been taken into account by the taxpayer at the time of the transfer, can lead to an adjustment of the transfer price. This implies that the OECD considers transfer pricing for HTVI to be accurate only if it is set in a rational manner. As the arm's length pricing should reflect the pricing that would be agreed between independent third parties, it is assumed that market participants would price HTVI in a completely rational manner.

The notion that decision making in enterprises is commercially rational has been challenged, as it is driven by human behaviour[60]. Human behaviour is subject to cognitive biases and decision traps[61]. As it is evidenced that trading hard-to-value stocks incurs a greater amount

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[58] OECD, "Draft Revised Guidance On The Transactional Profit Split Method", 2017, www.oecd.org/ctp/transfer-pricing/Revised-guidance-on-profit-splits-2017.pdf, 11-12, no. 43-46.

[59] P. PENELLE, "The OECD hard-to-value intangible guidance", *Int. Tax Rev.* 2017, Special ed., (11) 16.

[60] M. DE LANGE, P. LANKHORST and R. HAFKENSCHEID, "(Non-)Recognition of Transactions between Associated Enterprises: On Behaving in a Commercially Rational Manner, Decision-Making Traps and BEPS", *Int. Transfer Pricing J.* 2015, 85-94.

[61] De Lange et al. further argue that the contribution of funder of the intangible, who provides capital, is undervalued in the analysis of the OECD. A similar argument was made based on contract theory. See A.

of mistakes and increases human behavioural biases[62], irrationality when dealing with HTVI may be even more outspoken. It stands to reason that in case the valuation of an intangible is highly uncertain at the time of transfer, errors in forecasts or probability weightings can occur. Valuations including such errors may not necessarily be different from valuations made by independent parties at the outset of the transaction.

The tax authorities are also subject to cognitive biases. When taking the ex post outcome into account to evaluate the a priori available information, tax authorities are exposed to the hindsight bias. A successful outcome will make the upfront indications for success more plausible, while ex ante information signifying potential hazards will seem less relevant in hindsight. The posterior knowledge will make the outcome seem more inevitable than was the case at the time of transfer[63]. Tax authorities, unaware of the bias in their assessment of the ex ante information, will be inclined to assign a higher value to the intangible in retrospect than would be appropriate.

Taxpayers are expected to be able to demonstrate the appropriateness of the transfer pricing of an HTVI up to five years after the first external revenues. If not, they risk being subject to a one-sided adjustment by the tax authorities based on the actual financial results attributable to the HTVI. As the development of intangibles can span over several years, this in practice can imply a term exceeding a decade. After implementation of the OECD guidance, taxpayers would be liable to provide documentation for transfers dated years prior to the first mention of HTVI in OECD guidelines.

The timing can also conflict with the statutes of limitation. This problem should not be overstated, according to the OECD, as audit cycles typically display a time lag[64]. In the OECD's view, tax administrations should be encouraged to challenge the assumptions made by the taxpayer at the time of transfer of an HTVI. For that purpose, information should be sought during tax audits about developments leading to the ex post outcomes[65]. The OECD

MUSSELLI, "Intangible Revenues Assigned to the Developer and Not to the Funder Lacking "Development Monitoring Staff": OECD Transfer Pricing Anti-Abuse Rule Clashes with Economics of Contracts", *Int. Tax J.* 2017, issue 6, 37-43.

[62] See A. KUMAR, "Hard-to-Value Stocks, Behavioral Biases, and Informed Trading", *JFQA* 2009, 1375-1401.

[63] B. FISCHHOFF, "Hindsight is not equal to foresight: The effect of outcome knowledge on judgment under uncertainty", *J. Exp. Psychol. Hum. Percept. Perform.* 1975, (288) 297.

[64] OECD, "The Approach To Hard-To-Value Intangibles: Implementation Guidance For Tax Administrations", 2017, www.oecd.org/ctp/transfer-pricing/BEPS-implementation-guidance-on-hard-to-value-intangibles-discussion-draft.pdf, 3, no. 9.

[65] *Ibid.*

either does not recognise the time span required to develop certain intangibles, or it expects tax authorities to interpret technological developments and testing themselves. Tax administrations clearly lack the knowledge to perform such assessment, which is a main cause of the information asymmetry that formed the basis of introducing the guidance on HTVI in the first place.

Lasmiditan development timeline

In the pharmaceutical sector, the average time elapsed between the synthesis of a new drug and the start of clinical testing is nearly three years. The average time span between the start of clinical testing and the obtainment of marketing approval is on average eight years[66].

CoLucid entered into the initial licensing agreement with Lilly for lasmiditan in December 2005. CoLucid has taken the drug through preclinical and clinical testing, until Lilly acquired CoLucid with lasmiditan being in Phase III of clinical testing. The drug is still in Phase III of clinical testing twelve years after the initial license to CoLucid[67]. Lilly planned to submit the New Drug Application (NDA) to the FDA in the second half of 2018[68], at least thirteen years after the synthesis of the substance.

The OECD allows for large deviations if they occur more than five years after the start of commercialisation. Misjudgements about the useful life of an intangible, or long-term growth potential remain uncorrected. Depending on the industry, this may have significant impacts on the value of an intangible. Towards the end of the useful life, undertakings may agree to a diminishing royalty rate. Malicious MNEs may elect to aggressively decrease the royalty rate in later years, or to undervalue the HTVI based on cash flow projections for the outer years[69].

Adjustments to pricing structure

The OECD issued guidance, currently still in draft, that tax authorities can make adjustments to the pricing structure that has been agreed between associated enterprises[70]. In the TPG, the OECD explicitly stipulates tax authorities should only revert to such adjustment if similar

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[66] J. A. DIMASI, H. G. GRABOWSKI and R. W. HANSEN, "Innovation in the pharmaceutical industry: New estimates of R&D costs", *J. Health Econ.* 2016, (20) 24-25.
[67] ELI LILLY AND COMPANY, "Form 10-K", 2018, www.sec.gov/edgar, 33.
[68] *Ibid*. An NDA is the request for regulatory approval to market the drug.
[69] The effect of understating the cash flows in outer years will have a relatively limited effect. Due to the discounting of future cash flows, earlier years will have a larger weight in the valuation.
[70] *Supra*, 10, fn. 35.

conditions would have been agreed between independent parties at the time of the transfer[71]. This is merely a confirmation of the OECD's statement that the approach to HTVI is consistent with the arm's length principle.

The TPG of 2010 already mentioned that tax administrations could determine the pricing of HTVI on contingent pricing arrangements, if such arrangements would have been agreed between independent enterprises[72]. In the 2017 version, the OECD empowers the tax administration to use the ex post outcome to determine whether independent enterprises would have agreed to such price adjustment clause. It remains unclear how the actual value created by an intangible can provide much insight into the pricing structure independent companies would have agreed upfront.

Examples of adjustments by the OECD include "milestone payments, running royalties with or without adjustable elements, price adjustment clauses, or a combination of these characteristics"[73]. The pricing characteristics mentioned by the OECD may not all prove to be equally applicable.

Running royalties

Running royalties, which are payments per unit or value of sales, are common amongst independent third parties. Only a minority of licensing contracts include tiered royalties though[74], whereby the royalty percentage increases or decreases on a progressive scale. Such tiered royalties are used to address different commercial expectations of the contracting parties[75].

The actual profits derived from the licensed intangible can bring little insight into the different expectations that could have occurred between independent firms, or to what extent such differences would have existed. Large deviations from the initially forecasted profits may be an initial indication that large uncertainties existed a priori, and that differing expectations would be plausible between unrelated parties. Given the uncertainties surrounding HTVI, it

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[71] *Supra*, 10, fn. 34.

[72] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010*, Paris, OECD Publishing, 2010, 202, no. 6.32 and DOI: 10.1787/tpg-2010-en.

[73] OECD, “The Approach To Hard-To-Value Intangibles: Implementation Guidance For Tax Administrations”, 2017, www.oecd.org/ctp/transfer-pricing/BEPS-implementation-guidance-on-hard-to-value-intangibles-discussion-draft.pdf, 4, no. 12.

[74] T.R. VARNER, "An Economic Perspective on Patent Licensing Structure and Provisions", *Business Economics* 2011, (229) 233-235. Running royalties occur in 83% of all contracts in the dataset, as opposed to 15% for tiered royalties.

[75] *Ibid.*, 234.

can be expected that tiered royalties occur more often when dealing with HTVI than with intangibles in general.

A sample of agreements[76] indicates that contingent payments are indeed more common for HTVI. The contracts cover scenarios whereby a licensee further develops an intangible. There are also cases where the licensor commits to develop its own intangible property to suit the needs of the licensee. Each sampled contract had running royalties, whereby a 63% majority of the royalty rates were tiered.

Milestone payments

Milestone payments are typically dependent on technical progression in the development of the intangible[77]. The commercial success of the intangible may still be uncertain at those moments. The ex post outcome, when the commercial success has been established, may bring little additional insight into the appropriateness of the transfer pricing in such case.

In the vast majority of the sampled contracts, milestone payments are included. Such milestones nearly always include development milestones[78]. In 43% of the sampled contracts, payments for milestones related to sales revenues were included[79]. This illustrates that when managing HTVI, licensees seek to limit the upfront commitment, while licensors aim to capture the upside potential.

When tiered royalties are included, the contracts are more likely to include milestone payments of any kind. The tendency to include development milestone payments in a contract exists regardless of the royalty setup. Sales milestone payments are almost exclusively included together with development milestone payments. Parties seek in the first place to

[76] The sample is detailed in Attachment II. The contracts were extracted from the database on www.lawinsider.com, which contains agreements that have been filed with the SEC. As a result, each contract always involves at least one US company, limiting the diversity of the sample. Contracts in the category “Development And License Agreement” were selected. Agreements involving the cross-licensing of intangibles were excluded from the sample. The size of the sample is insufficient to be deemed statistically representative for the entire population. The intangible property in the agreements is subject to further development and initial commercialisation. This indicates most of the sampled agreements will cover HTVI, although some agreements will deal with intangibles whose associated profits are more predictable.

[77] T.R. VARNER, "An Economic Perspective on Patent Licensing Structure and Provisions", *Business Economics* 2011, (229) 234.

[78] Milestone payments related to regulatory approvals are categorised under development milestone payments. Upfront fees, while sometimes characterised as such in the agreements, were not included as milestone payments.

[79] The filing of the contracts with the SEC is done in a redacted form. As the milestones leading to contingent payments are sometimes entirely omitted, it is possible sales milestones are missed and the actual proportion is higher.

safeguard against an unsuccessful development of the HTVI. Additionally, often one or more variable remuneration provisions are included that depend on the commercial success.

	Development milestone payments	Sales milestone payments	Absence of milestone payments
Tiered royalties	93%	47%	7%
Non-tiered royalties	80%	36%	16%
Total	88%	43%	10%

Table 1: Milestone payments in HTVI contracts

Price adjustment clauses

Price adjustment clauses should be seldom implemented, as independent parties hardly ever agree on clauses to adjust pricing depending on subsequent events[80]. Licensing agreements would be subject to a revision of the royalty when they contain termination or renegotiation clauses, or when they are short-term renewable agreements. These conditions are not met in the majority of contracts between independent parties[81].

Independent contracting parties would be reluctant to include renegotiation clauses, because of the "hold-up" problem. After initial investments are done by the transferee, the transferor of the HTVI could open renegotiations to increase the price. For example, the licensee may have invested in production facilities to manufacture a new product. If the licensor initiates renegotiations, the licensee will be forced to accept a higher price, or stand to lose its entire investment without any compensation. Excluding renegotiation clauses will safeguard the parties against such hold-up[82].

HTVI license to CoLucid

The license agreement between Lilly and CoLucid for the HTVI lasmiditan contained a number of variable pricing elements, besides a shareholding by Lilly in the capital of CoLucid[83].

An upfront lump-sum payment of $1 million was made. Milestone payments were included for the filing of certain regulatory requests and the achievement of approvals. The amounts payable ranged from $1.5 million to $11 million, depending on the applicable geographic

[80] M. MARKHAM, *The Transfer Pricing of Intangible Assets*, The Hague, Kluwer, 2005, 82.
[81] W. S. MCSHAN, M. J. MERWIN, G. B. STONE AND D. R. WRIGHT, "A Review of Third-Party License Agreements: Are Periodic Adjustments Arm's Length?", *The Tax Exec.* 1989, (353) 356-357.
[82] W. P. ROGERSON, "Contractual Solutions to the Hold-Up Problem", *Rev. Econ. Stud.* 1992, (777) 790.
[83] COLUCID PHARMACEUTICALS, INC., "Amendment no. 3 to Form S-1 registration statement - Exhibit 10.10", 2015, www.sec.gov/edgar, 8-10.

market. A $10 million milestone payment was also due when net sales revenues surpassed a set threshold. Each newly approved application for the drug also triggered a $1 million payment per geographic market.

A two-tiered running royalty of 8% and 11% on net sales revenues was included. The royalty rate was reduced for a country when generic alternatives conquered a predefined market share in that country[84].

Lilly had the option to terminate the agreement in case of a material breach of the contract by CoLucid. Likewise, CoLucid could terminate the agreement upon a material breach by Lilly. Additionally, CoLucid could terminate the agreement when it reasonably believed that lasmiditan could not be commercially further developed. In this case, there would have been no risk for a hold-up, since all rights to the HTVI would have transferred back to Lilly.

To further ensure compliance with the arm's length principle, tax administrations should recognise adjustments are to be regarded in view of the overall pricing structure. The optimal combination of up-front payments, milestone payments and royalties varies depending on the ex ante situation of the contracting parties[85]. These instruments are often targeted to address information asymmetries between contracting parties[86]. Associated enterprises may not spontaneously use them to the same extent as independent contracting parties. It is advisable for taxpayers to include contingent payment provisions in the transfer agreement, to avoid potential imposition of unsuitable arrangements by the tax authorities.

Conclusion

The OECD issued guidance on HTVI whereby tax authorities can judge transfer pricing in retrospect using the actual outcome as presumptive evidence. This guidance is situated within the ALP. In evaluating the appropriateness of transfer pricing for HTVI, tax authorities should allow room for error in the ex ante projections made by the taxpayer. Decision making is prone to irrational behaviour, also between independent parties. Taxpayers should reasonably be expected to make honest mistakes about future projections, without ascribing deviations between the anticipated and actual outcome to unforeseeable events only.

[84] Some of the sampled agreements contain similar arrangements. Such arrangement is independent of the actual financial results of the licensee.

[85] See P. CRAMA, B. DE REYCK and Z. DEGRAEVE, "Milestone Payments or Royalties? Contract Design for R&D Licensing", *Oper. Res.* 2008, 1539-1552.

[86] For a description of the economics of information asymmetry, see J.E. STIGLITZ, "The Contributions of the Economics of Information to Twentieth Century Economics", *QJE* 2000, 1441-1478.

Before making adjustments to pricing structures, tax administrations should be aware of the considerations involved in selecting the different attributes. Each element in the pricing structure can address a particular need, tailored to the situation and relationship between the contracting parties.

Pricing characteristics that are commonly agreed between independent parties may not be applicable to the specific situation of the taxpayer. Due to the uncertainty surrounding HTVI, the exclusive use of lump-sum payments and fixed royalties is unlikely to be market conform[87]. Sales milestone payments and tiered royalties can, although commonly used, be omitted in market-conform agreements. These provisions, that have the potential of bringing a larger incremental share of the value of successful HTVI to the licensor, are absent in a significant portion of contracts between independent parties.

Price adjustment clauses are rarely agreed to in contracts between independent parties. Any clause with the potential to reopen negotiations is carefully limited by diligent agents. Triggers may include misconduct by the counterparty. Unconditional termination and renegotiation clauses expose especially the licensee to a “hold-up” situation. The reluctance of independent parties to agree to such clauses should preclude the tax authorities from imposing them on intercompany transactions.

Taxpayers may feel obligated to include price adjustment clauses or similar provisions in their intercompany contracts, even though they would not always agree to such conditions in the external market. This way, the taxpayer can select the most suitable milestones or sales measurement to be used as the basis for contingent payments. It would further ensure the taxpayer would be able to correct transfer pricing in two directions, instead of solely being exposed to adjustments by the tax authorities in their favour.

[87] Upfront payments are often included in agreements, in combination with contingent payments.

BELGIUM

Belgium has introduced an explicit reference to the arm's length principle in its legislation in 2004. Before that time, the tax authorities applied the guidance of the OECD on arm's length pricing by invoking several implicit references in the law.

The Belgian Income Tax Code contains no definition for intangibles. The definition of intangibles in the TPG conflicts with that of the Belgian accounting legislation. This should not pose an issue, since legal or accounting definitions are of lesser importance for transfer pricing analyses[88].

Arm's length principle

In 2004, Belgium has introduced article 185 § 2 in the Income Tax Code (WIB)[89], reflecting the wording and the intention of Article 9 of the model convention. The tax administration can revisit the taxable profits from intercompany business upwards or downwards, to align them with the arm's length outcome. Until the introduction of art. 185 § 2 WIB, the Belgian legislation did not provide the option to adjust the taxable base of associated enterprises or permanent establishments to ensure an arm's length pricing[90].

Abnormal and benevolent advantage

The tax administration has been applying the OECD guidelines before the introduction of art. 185 § 2 WIB by citing implicit references in articles throughout the Income Tax Code, mainly article 26 WIB. It states that abnormal and benevolent advantages granted by a company are

[88] OECD, *TPG 2017*, 249, no. 6.6. See also T. VANWELKENHUYZEN, "Belgium" in INTERNATIONAL FISCAL ASSOCIATION (ed.), *IFA Cahier Volume 102b The future of transfer pricing*, The Hague, Sdu, 2017, (155) 160.

[89] Wet tot wijziging van het Wetboek van de inkomstenbelastingen 1992 en de wet van 24 december 2002 tot wijziging van de vennootschapsregeling inzake inkomstenbelastingen en tot instelling van een systeem van voorafgaande beslissingen in fiscale zaken, *BS* 9 July 2004.

[90] MvT bij Wet tot wijziging van het Wetboek van de inkomstenbelastingen 1992 en de wet van 24 december 2002 tot wijziging van de vennootschapsregeling inzake inkomstenbelastingen en tot instelling van een systeem van voorafgaande beslissingen in fiscale zaken, *Parl.St.* Kamer 2003-04, no. 51-1079/1, 5.

added to the own profits, unless such benefits are included in the taxable base of the recipient. This "escape clause" is not applicable when the recipient is

i. an associated enterprise resident in a foreign jurisdiction;
ii. resident in a jurisdiction where he is subject to no taxation or to a tax system that is markedly more favourable than the one applicable to the Belgian entity granting the advantage; or
iii. a taxpayer that has common interests with the entities referenced in i) and ii).

The Court of Cassation has defined the terms abnormal and benevolent used in article 26 WIB[91]. The term abnormal should be interpreted as "being, in the given economic circumstances, conflicting with the normal course of business, with established trade principles or habits". Benevolent means "without obligation or counter value".

The tax authorities identified art. 26 WIB as a direct reference to the arm's length principle, as stated in the circular letter by the Belgian tax administration dated 28 June 1999[92]. Based on article 26, the taxable base of Belgian taxpayers can be increased for non-arm's length transactions with foreign group members. The circular letter references and follows the most recent version of the TPG that was available at that time, dated 1995.

Case law has been more reluctant than the tax authorities to equate the law on abnormal and benevolent advantages to the ALP. The Court of Cassation stated that the abnormal and benevolent advantage has to be judged from the receiver's perspective[93]. In that respect, the Court of Appeal in Liège has confirmed that no abnormal benefit exists if the recipient does not make a profit when reselling the purchased products[94]. A two-tiered structure, whereby a foreign transferee would pass the payments intangibles on to other group members under similar conditions, would put a non-arm's length transfer price outside the scope of art. 26 WIB[95]. The actual outcome for the middleman would be unrelated to the actual value of the intangible for the wider group.

In another instance, the Court of Appeal in Liège has confirmed that no abnormal or benevolent advantage is granted by an associated enterprise, if the benefit is indirectly

[91] Cass. 10 April 2000, AR F.99.0005.F.
[92] Circ. no. AFZ/98-0003, 28 June 1999, www.fisconet.be.
[93] Cass. 20 September 1972, *Arr.Cass.* 1973, (78) 79.
[94] Liège 8 February 1984, *FJF* 85/8.
[95] E.g. the UK affiliate of Starbucks, Alki LP, received royalties from a Dutch subsidiary that were deemed not be at arm's length. Payments of comparable magnitude were made to US group members. *Infra*, 37.

compensated to that enterprise by other members of the group[96]. The Court of Appeal in Brussels has ruled that in order for this argument to be valid, it is required that there is an overall balance in the group[97]. The Belgian taxpayer must demonstrate that the abnormal and benevolent advantage it has granted to a foreign sister company is equal to the compensating advantage received from another sister company in a linked transaction. Traditionally, courts judged more pragmatically on whether there was an overall balance. The actual outcome was deemed to be irrelevant, as long as there was a compensating intention at the time of entering into the transaction[98]. If courts continue to judge on the ex post outcome, contingent payments have to be put in place by the taxpayer to ensure such group balance for HTVI transfers.

Courts have established that the tax administration can demonstrate an advantage based on the ALP. If the taxpayer acknowledges this opinion, he is still in the position to prove that the non-arm's length pricing is not abnormal or benevolent. The advantage can be justified by market conditions or circumstances specific to the contracting parties[99]. The Court of Appeal in Brussels ruled it was not an abnormal or benevolent advantage when a Belgian subsidiary forfeited the receivable from its financially troubled French parent company, while the parent agreed to drop a significantly smaller claim on the Belgian entity in return[100]. According to the Court, any independent party would favour a certain smaller recovery over an uncertain outcome in that situation. A similar reasoning could lead the Court to accept the transfer of an HTVI under a lump-sum payment. In certain situation, for example of financial distress, independent companies could prefer such arrangement over an arrangement with a lower upfront payment and uncertain contingent payment mechanisms.

Case law has also established that no abnormal or benevolent advantage exists if a group member foregoes a profit for the wider benefit of the group[101], specifically if a parent company seeks to avoid or minimise losses on shareholdings. The Court of Appeal in Ghent suggests that minimising losses on a minority shareholding can already be sufficient as justification for an advantage, so that it is not considered to be abnormal[102]. Intangibles can

[96] Liège 21 May 1997, *Fisc.Koer.* 1997, 436 (resume), note P. CAUWENBERGH.
[97] Brussels 12 April 2002, *FJF* 2002/253 and *TFR*, 2003, 564, note B. VAN HONSTÉ.
[98] Liège 21 May 1997, *Fisc.Koer.* 1997, 436 (resume), note P. CAUWENBERGH.
[99] *Ibid.*
[100] Brussels 17 February 1999, *FJF* 2000/196.
[101] N. REYPENS, "Belgium" in DUFF & PHELPS (ed.), *Guide to International Transfer Pricing: Law, Tax Planning and Compliance Strategies*, Alphen aan den Rijn, Kluwer, 2014, (183) 198.
[102] Ghent 29 April 1999, *A.F.T.* 1999, (315) 317-318 (resume), note P. CAUWENBERGH.

qualify as HTVI in case these intangibles are used to develop other HTVI[103]. Parent companies could for example license intangible property to subsidiaries for the development of new intangibles for considerations below the arm's length value, if that subsidiary is in financial distress.

Ex post outcome

The tax administration recognises in the circular letter of 28 June 1999 that intangibles can be hard to value, e.g. when the intangible has been recently developed. In case important value can be attributed to that HTVI after a certain period, the transfer pricing should not be automatically adjusted. Events that occurred after the transfer of the intangible should not be taken into account according to the ALP, unless such events were reasonably foreseeable. Posterior elements that indicate a higher value should be removed, if the taxpayer can prove his analysis dating from the time of transfer.

Transfer pricing is determined on future perspectives. Nevertheless, according to the Court of Appeal in Liège, the evaluation of the transfer pricing should be exclusively based on the appreciation that the taxpayer could have made at the time of the transfer[104]. The notion of considering the ex post outcome to evaluate the appropriateness of the ex ante projections is rejected[105].

Investigation

Tax authorities can invoke a factual presumption in accordance with art. 340 WIB using any evidence allowed by common law. Art. 1349 of the Civil Code defines a presumption as a deduction from a certain fact to conclude to an unknown fact. This evidence is then rebuttable by the taxpayer. The posterior results are a certain fact. To question the appropriateness of the anterior pricing, a deduction is required beyond establishing that these posterior results differ significantly from the forecast. Only then, the taxpayer will have to counter the presumption[106].

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[103] *Supra*, 6.

[104] Liège 13 December 2002, *FJF* 2003/76.

[105] This can be regarded as a change in opinion by the Court of Appeal in Liège. In an earlier case, the Court ruled no abnormal or benevolent benefit existed, based on a report that stated that the recipient had not made a profit in reselling the goods. As such, the Court applied hindsight itself. *Supra,* 25, fn. 94.

[106] A specific legal presumption is included in art. 344 § 2 WIB, concerning the sale or contribution of intangibles to a recipient residing in a low-tax jurisdiction. This legal presumption can be disproven. This rule applies not only to associated enterprises, and is therefore broader than the ALP.

The audit period is limited by art. 333 WIB to in principle three years after the end of the taxable period. This term can be extended by an additional four years if the tax administration has clear indications of tax evasion. HTVI can be transferred while still in the development phase or to support the development of other intangibles. Actual profits can possibly only occur several years after the transfer[107].

Tax rulings

The Belgian tax administration can issue APAs based on the Law of 24 December 2002[108]. Tax rulings are issued before a transaction is effective for tax purposes. Such ruling is valid for a maximum term of five years, unless the object of the request justifies a longer term. When the transactional profit split method is used in relation to intangibles, the tax administration can include the requirement for a periodic revision of the split or a revision in case of material changes in the economic circumstances in the APA[109]. The OECD's intent to impose contingent payments on the taxpayer can thus be captured under APAs, regardless of the initial compensation structure.

Reconciling HTVI with the Belgian legal system

The implementation of the guidelines as written by the OECD will encounter some challenges in the current legislative framework. In the context of HTVI, the limited audit term of three years can prove to be short to assess the actual value, since HTVI may be commercially exploitable only several years after the transfer.

To allow the ex post outcome to serve as presumptive evidence, Belgian legislation requires a logical reasoning to conclude the events influencing that outcome were foreseeable by the taxpayer. HTVI by their nature have uncertain perspectives. It can by default be expected that the ex post outcome differs significantly from the projections that were made a priori.

The Belgian tax authorities acknowledge that hindsight should in principle not be used to evaluate the appropriateness of transfer pricing. According to the circular letter of 28 June 1999, events following the transfer should only be taken into account if such events are

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[107] *Supra*, 18.

[108] Art. 20-28, Wet van 24 December 2002 tot wijziging van de vennootschapsregeling inzake inkomstenbelastingen en tot instelling van een systeem van voorafgaande beslissingen in fiscale zaken, *BS* 31 December 2002.

[109] Decision 21 October 2014, no. 2014.552, www.fisconetplus.be, no. 77.

reasonably foreseeable. Under Belgian legislation concerning legal presumption, it is up to the tax authorities to demonstrate posterior events or developments were foreseeable at the time of the transaction. It remains questionable whether the use of the ex post value as presumptive evidence will at all be accepted by the courts. Case law confirmed posterior information should not be used in evaluating the transfer pricing arrangement.

When dealing with abnormal and benevolent advantages, courts have on multiple occasions allowed the ALP as a basis to evaluate the appropriateness of transfer pricing. However, the definition of abnormal and benevolent advantages as given by the Court of Cassation is not aligned with the definition of the ALP. The Belgian courts consider other economic drivers besides the market value of the underlying intangible. Due to for example the financial situation of one of them, contracting parties can agree to transacting under terms that are different from the arm's length price. Omitting contingent compensation provisions for the benefit of a higher lump sum payment would under these circumstances not necessarily be considered as an abnormal and benevolent advantage.

Belgian courts recognise that individual members of a corporate group forego a part of their immediate profits for the wider benefit of the group. Contracting associated enterprises may have other and broader interests than independent parties would have. To safeguard the value of shareholdings or the commercial reputation, associated enterprises can transfer HTVI at compensation levels that depart from the arm's length pricing.

The existence of an abnormal or benevolent advantage has to be evaluated from the receiver's perspective. The ex post profit levels of HTVI that would serve as presumptive evidence, are those realised by the counterpart of the Belgian taxpayer. Non-arm's length transfers in more complex corporate structure, involving royalty payments through several affiliates, can fall outside the scope of art. 26 WIB. Art. 185 § 2 WIB can offer a more suitable vehicle to address such constructions.

The guidance on HTVI is not applicable if a controlled transaction is covered by a bilateral or multilateral APA. In its ruling practice, the tax authorities have shown to include reappraisals of the upfront transfer pricing. If not done explicitly, the maximum term of five years provides a periodic reassessment opportunity. As such, the spirit of the HTVI guidance can still be applied when APAs are issued.

EUROPEAN UNION

Several institutions within the European Union have engaged in the transfer pricing debate. The Court of Justice of the European Union (CJEU) has judged on the compatibility of some national rules related to transfer pricing with the fundamental freedoms of the EU. The European Commission (EC) has launched several investigations against State aid, based on the Treaty on the Functioning of the European Union (TFEU). These investigations fit in the context of the Action Plan on Corporate Taxation[110] launched by the EC.

Court of Justice of the European Union

According to settled case law, direct taxation falls within the competence of the Member States, which nonetheless have to exercise this competence in line with EU law[111]. Multiple CJEU cases have dealt with aspects of cross-border transfer pricing. National legislation that, explicitly or more often implicitly, concerns transfer pricing has been tested against the fundamental freedoms of the TFEU. Cases involving transfer pricing related legislation are typically tested against the freedom of establishment, covered by art. 49 TFEU. The cases presented to the Court involve a different legal treatment of domestic associated enterprises compared to those established in other Member States. Such impediment of the freedom of establishment can be justified by objectives of public interest and if the rule does not go beyond what is required to achieve those objectives[112].

[110] Communication from the Commission to the European Parliament and the Council (EC). A Fair and Efficient Corporate Tax System in the European Union: 5 Key Areas for Action, 17 June 2015, COM(2015) 302 final.

[111] CJEU 12 December 2002, no. C-324/00, ECLI:EU:C:2002:749, 'Lankhorst-Hohorst', pt. 26; CJEU 8 March 2001, no. C-397/98 and C-410/98, ECLI:EU:C:2001:134, pt. 37; CJEU 13 April 2000, C-251/98, ECLI:EU:C:2000:205, pt. 17; CJEU 29 April 1999, C-311/97, ECLI:EU:C:1999:216, pt. 19; CJEU 27 June 1996, no. C-107/94, ECLI:EU:C:1996:251, pt. 36; CJEU 11 August 1995, no. C-80/94, ECLI:EU:C:1995:271, pt. 16.

[112] L. HINNEKENS, *Europese Unie en directe belastingen*, Ghent, Larcier, 2012, 299, no. 124.

Transfer pricing cases

In the case Lankhorst-Hohorst[113], a German taxpayer paid interest to an affiliated company in the Netherlands. The German tax authorities regarded these interest payments as covert dividend payments and taxed them accordingly at 30%. Such reclassification would not have taken place if the recipient had been resident in Germany. The Court ruled that the legislation in Germany was conflicting with the freedom of establishment, and that such conflict was not justified.

A second case concerning undercapitalisation, Thin Cap Group Litigation[114], was concluded in a similar fashion. The UK legislation limited the deductibility of interest payments on loans granted by an affiliated company which is resident in another Member State to the reasonable commercial amount. Such restriction was not imposed on interest payment paid to a resident associated enterprise. The CJEU concluded this was an unjustified breach of the freedom of establishment.

The case of Société de Gestion Industrielle SA (SGI)[115] addressed the compatibility of the Belgian art. 26 WIB with art. 48 TFEU. SGI had granted an interest-free loan to its 65% subsidiary and paid excessive director payments to its shareholder-director. The Belgian tax authorities considered these to be abnormal and benevolent advantages, and the advantage was added to the taxable profits of SGI. The restriction on freedom of establishment was found to be justified and proportionate in view the balanced allocation of the power to tax between the Member States and the prevention of tax avoidance.

Transfer pricing and the CJEU

The CJEU recognises that corporations should not be allowed to freely shift their profit and loss between Member States. This would endanger the balanced allocation of taxation powers between Member States[116].

Artificial constructions

The Court has accepted the combat against wholly artificial constructions as a ground of justification to restrict the freedom of establishment[117]. For such constructions, a Member

[113] CJEU 12 December 2002, no. C-324/00, ECLI:EU:C:2002:749, ‘Lankhorst-Hohorst’.
[114] CJEU 13 March 2007, no. C-524/04, ECLI:EU:C:2007:161, ‘Thin Cap Group Litigation’.
[115] CJEU 21 January 2010, no. C-311/08, ECLI:EU:C:2010:26, ‘SGI’.
[116] *Ibid.*, pt. 62; CJEU 18 July 2007, C-231/05, ECLI:EU:C:2007:439, ‘Oy AA’, pt. 55.

State cannot be held responsible to avoid double taxation by the treatment in another Member State[118]. Constructions that reflect an economic reality have to be accepted, despite the existence of tax motives to establish such setup[119]. Under this reasoning, the CJEU may not allow tax authorities to introduce changes to the arrangements governing the transfer of HTVI, including the introduction of contingent payments. The fact independent undertakings may agree to contingent payment provisions can be considered insufficient to apply them to dealings between associated enterprises.

It should be noted that the concept of "economic reality" differs between the CJEU and the OECD. While the OECD aims to align the outcome of the arm's length pricing with value creation, the CJEU assigns a more significant value to the legal status of an arrangement. Intra-group contractual arrangements fulfil the notion of "economic reality" if they are legally valid, factually implemented and commercially sound[120]. The ALP test can serve as a valid starting point to analyse whether a construction is established for tax abuse purposes only[121].

The CJEU demonstrates the importance it attaches to the legal structure, when it judges on the profit allocation within a corporate group. The Court rejects the argument that certain governments made, that adjustments to cross-border transfer pricing are simply a profit allocation within a corporate group. The companies involved are distinct legal entities, each with a separate tax liability[122].

If a tax administration of a Member State suspects a wholly artificial construction, the taxpayer should be able to demonstrate the commercial reasons behind the construction without undue administrative burden[123]. The implication of this statement is that transactions which were not conducted at arm's length should still be accepted by tax administrations if justified by commercial incentives[124].

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[117] CJEU 21 January 2010, no. C-311/08, ECLI:EU:C:2010:26, 'SGI', pt. 65; CJEU 13 March 2007, no. C-524/04, ECLI:EU:C:2007:161, 'Thin Cap Group Litigation', pt. 72; CJEU 12 December 2002, no. C-324/00, ECLI:EU:C:2002:749, 'Lankhorst-Hohorst', pt. 37.

[118] CJEU 13 March 2007, no. C-524/04, ECLI:EU:C:2007:161, 'Thin Cap Group Litigation', pt. 88.

[119] CJEU 12 September 2006, no. C-196/04, ECLI:EU:C:2006:544, 'Cadbury Schweppes', pt. 65.

[120] W. SCHÖN, "Transfer Pricing Issues of BEPS in the Light of EU Law", *BTR* 2015, (417) 424-425.

[121] CJEU 29 June 2006, C-524/04, ECLI:EU:C:2006:436, opinion A. GEELHOED, pt. 66.

[122] CJEU 21 January 2010, no. C-311/08, ECLI:EU:C:2010:26, 'SGI', pt. 51-52.

[123] *Ibid.*, pt. 71; CJEU 13 March 2007, no. C-524/04, ECLI:EU:C:2007:161, 'Thin Cap Group Litigation', pt. 82.

[124] W. SCHÖN, "Transfer Pricing, the Arm's Length Standard and European Union Law" in I. RICHELLE, W. SCHÖN and E. TRAVERSA (eds), *Allocating Taxing Powers within the European Union*, Heidelberg, Springer, 2013, (73) 96; L. HINNEKENS, *Europese Unie en directe belastingen*, Ghent, Larcier, 2012, 493, no. 205.

If the ex post outcome would provide presumptive evidence to evaluate the appropriateness of the transfer pricing, such evidence would be rebuttable by the taxpayer, according to the OECD. To this end, the company should be able to demonstrate the ex ante pricing took all foreseeable events into account. This requirement can be deemed by the CJEU to put an excessive administrative burden on the taxpayer. In practice it can prove cumbersome to prove that certain events were unforeseeable at the time of the inception of the transaction. It may also be hard to validate the probabilities used in the ex ante pricing correctly reflected the likelihood of possible outcomes.

CoLucid probability of success

At the time of the IPO, the lasmiditan intangible property of CoLucid was valued at $76 million. Lilly valued the intangible at $858 million upon acquisition[125]. The implied probability of success can be said to amount to 9% at the time of the IPO[126].

It can be shown which clinical test results have increased the probability of success of the intangible, and consequently the value. Demonstrating why the likelihood at the outset would not have been higher, will require substantially more documentation. The upfront probability is low. Small adjustments to the probability have a large relative impact on the price. In retrospect, arguments that lower the probability will seem less valid than those supporting a higher likelihood of success[127]. The resulting administrative burden can be excessive.

Legal certainty

Taxpayers should be able to determine the scope of a legal provision prior to entering into a transaction. The CJEU has judged that rules ought to be sufficiently clear and precise, and the consequences foreseeable. This especially holds in case the rules could have negative consequences for individuals and companies. This requirement serves to preserve the principle of legal certainty[128]. Upon transfer of HTVI, future prospects of that intangible are difficult to assess, also for the taxpayer. The value assigned to the HTVI is subject to many uncertain assumptions, and may differ due to unpredictable aspects from the ex post outcome. The OECD recommends testing the appropriateness of the transfer pricing against the future

[125] *Supra*, 13.
[126] This greatly simplified calculation is for illustrative purposes only. The calculation assumes full certainty at the time of acquisition by Lilly, disregards the time value in the discounted valuation and other changes in the projections regarding the development and commercialisation of lasmiditan.
[127] See also *supra*, 17.
[128] CJEU 5 July 2012, C-318/10, ECLI:EU:C:2012:415, ‘SIAT’, pt. 57-58.

result. As a consequence, enterprises are unable to determine the impact of the rule when entering into the transaction. This notion conflicts with the requirement the CJEU expressed that a rule should be accurate and that taxpayers have to be able to forecast its effect.

Burden of proof

The CJEU has not taken a clear stance yet on the burden of proof. It can be concluded this is primarily a matter of domestic law in the Member State[129], while another reasoning concludes that the burden of proof should initially lay on the tax administration in order to withstand the proportionality test[130].

Under the HTVI approach, the OECD essentially puts the burden of proof with the taxpayer. As soon as the profits recorded after the fact exceed a certain threshold, the taxpayer is held accountable to prove the upfront determined conditions reflect an arm's length pricing. It is not implausible the CJEU would reject the notion that the tax administration carries virtually no burden of proof.

Conclusion

The OECD guidance on HTVI may face difficulties when its compatibility with CJEU case law is tested. If Member States apply the same regulations to purely domestic situations and to cross-border transactions, the fundamental freedoms of the EU will not be infringed. From a Member State perspective, this may be the surest tactic to fully implement the guidance.

European Commission

Art. 107 § 1 TFEU determines that "any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market". The European Commission has launched several investigations into transfer pricing arrangements lately based on this provision.

[129] D. WEBER, "Abuse of Law in European Tax Law: An Overview and Some Recent Trends in the Direct and Indirect Tax Case Law of the ECJ – Part 2", *European Taxation* 2013, (313) 319.
[130] P. BAKER, "Transfer Pricing and Community Law: The SGI Case", *Intertax* 2010, (194) 196.

Recent cases

The EC has started investigating whether APAs issued by Member States imply State aid to individual companies. If so, the EC can demand the Member State to recover the tax advantage granted under the APA.

Starbucks

The Netherlands has granted State aid to coffee roaster and retailer Starbucks, according to the investigation by the Commission[131]. Dutch subsidiary Starbucks Manufacturing EMEA BV (SMBV) owns and operates the only Starbucks owned coffee roasting plant outside the United States. SMBV is a subsidiary of Starbucks Coffee EMEA BV, in turn a subsidiary of Alki LP. This limited partnership is based in the UK and holds intangible rights related to the Starbucks brand and the know-how of coffee roasting. These intangibles were obtained under a cost-sharing arrangement (CSA)[132], and as such might qualify as HTVI under the OECD definition. Neither Alki LP, nor its corporate partners had any employees.

The APA determined the appropriate remuneration for SMBV based on the TNMM as a percentage of its operating costs. Any taxable earnings that exceeded the profit level set forth in the APA were paid out as a royalty to Alki LP, who in turn made payments to US group members under the CSA. The royalty paid for the know-how of coffee roasting by SMBV was found to be unusual.

SMBV purchased all its green coffee beans from its Swiss sister company Starbucks Coffee Trading Company SARL (SCTC). The EC established that the price SMBV paid to its Swiss-based sister company for green coffee beans was no longer at arm's length after an unwarranted price increase in 2011. As a result, purchase costs for green coffee beans exceeded revenues from roasted beans. The APA did not cover this intercompany transaction. The EC's opinion is that this should have been identified as a controlled transaction and therefore should have been part of the APA of 2008[133]. SCTC would consequently not have been able to deviate from the original pricing without amending or replacing the APA.

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[131] Commission Decision (EU) 2017/502 of 21 October 2015 on State aid SA.38374 (2014/C ex 2014/NN) implemented by the Netherlands to Starbucks, *OJ* 29 March 2017, L83, 38-115.

[132] A CSA is similar to a CCA under the TPG, though specific to the development of intangibles only. Under the US Code, Treas. Reg. § 1.482-7(b) defines a cost-sharing arrangement as "an arrangement by which controlled participants share the costs and risks of developing cost shared intangibles in proportion to their [shares of reasonably anticipated benefits]".

[133] Commission Decision (EU) 2017/502 of 21 October 2015 on State aid SA.38374 (2014/C ex 2014/NN) implemented by the Netherlands to Starbucks, *OJ* 29 March 2017, L83, (38) 98, no. 348.

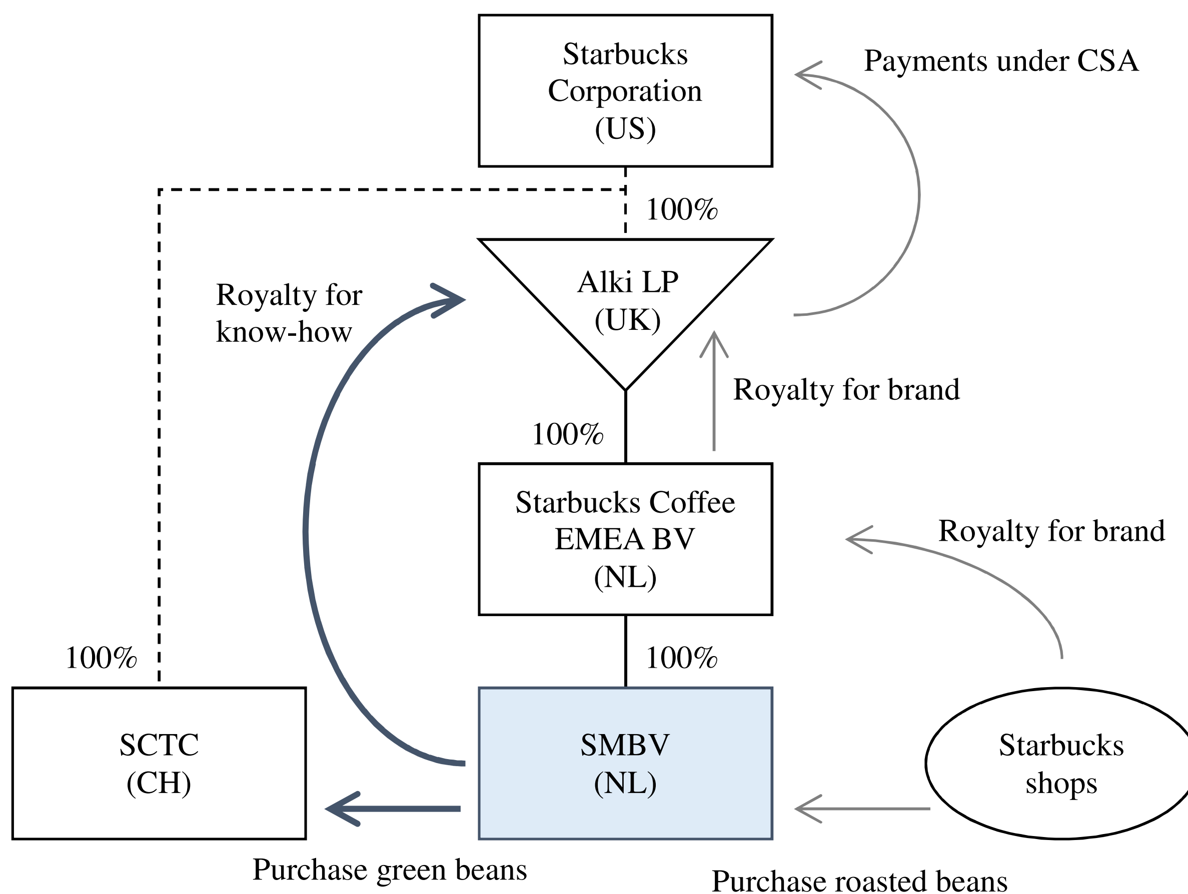

Figure 3: Starbucks structure

Fiat

Car manufacturer Fiat has received State aid in Luxembourg, according to a decision by the EC[134]. Fiat Finance and Trade Ltd (FFT) provided treasury services and financing to the European affiliates of the Fiat group, with the exception of the Italian group members. To this end, FFT arranged cash pooling activities, external funding as well as intra-group loans and deposits. The Luxembourg tax authorities had agreed to a fixed annual taxable profit, based on the TNMM. This profit level was achieved by managing the interest paid on the intra-group deposit FFT accepted. Such remuneration for the group members was evaluated not to be at arm's length by the Commission.

Apple

Profit allocation was the core of the investigation into State Aid for Apple, more than actual transfer pricing[135]. Ireland had issued two APAs for Apple Sales International (ASI) and

[134] Commission Decision (EU) 2016/2326 of 21 October 2015 on State aid SA.38375 (2014/C ex 2014/NN) which Luxembourg granted to Fiat, *OJ* 22 December 2016, L351, 1-67.
[135] Commission Decision (EU) 2017/1283 of 30 August 2016 on State aid SA.38373 (2014/C) (ex 2014/NN) (ex 2014/CP) implemented by Ireland to Apple, *OJ* 19 July 2017, L187, 1-110.

Apple Operations Europe (AOE). Though incorporated in Ireland, both companies were considered to be managed and controlled in the US. ASI and AOE operated in Ireland through branches. Neither of the head offices had any employees. For US tax purposes, the companies were not treated as US residents.

ASI and AOE participated in a CSA with US group members, from which they derived rights to intangible property. The Irish branches were involved in operational activities and compensated for these less complex activities. The remainder of the profit related to the intangibles was allocated to the head offices under the tax ruling. There they remained untaxed, as the head offices were not treated as a resident by any tax jurisdiction. As the head offices had no employees or activities, the EC ruled these earnings should have been awarded to the Irish branches instead.

Amazon

The EC concluded that online retailer Amazon was the recipient of State aid by Luxembourg[136]. The investigated APA covered two subsidiaries of the Amazon group, Amazon EU SARL[137] (LuxOpCo) and Amazon Europe Technologies Holding SCS (Lux SCS).

Lux SCS is a holding company for intellectual property, and holds all shares of LuxOpCo. It is a limited partnership and as such has no separate tax personality. It is transparent for tax purposes. The partners, US-based subsidiaries, are directly liable for the corporate income tax for the portion of the profit that is allocated to each of them. The IP rights held by Lux SCS were obtained by a buy-in payment and its participation in a CSA with US group members[138]. Lux SCS licenses the IP rights to LuxOpCo.

LuxOpCo operates all Amazon websites in Europe, and holds all shares of the EU marketing companies outside of Luxembourg. All EU sales are recorded on the books of LuxOpCo. The operating profit was set as a percentage of operating expenses, restricted within a bandwidth of EU sales. The remainder of the earnings was paid to Lux SCS under the form of a royalty.

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[136] Commission Decision of 4.10.2017 on State aid SA.38944 (2014/C) (ex 2014/NN) implemented by Luxembourg to Amazon, 4 October 2017, C(2017) 6740 final.

[137] Amazon EU SARL holds all the shares of several other Luxembourg subsidiaries, with which it forms a fiscal unity. For corporate income tax purposes, the subsidiaries are deemed to be absorbed by the parent company.

[138] For the full corporate structure, see W. BYRNES, "Byrnes' Analysis of the 200+ page Amazon Decision. Is it the Death Knell of the Income Method and Inclusion of Employee Stock Compensation for Cost Sharing Agreement Valuation?", *Kluwer International Tax Blog*, 2017, http://kluwertaxblog.com/2017/03/24/is-amazon-com-inc-the-death-knell-of-the-irscost-sharing-agreement-valuation-approach/.

The assessment was presented as the transactional profit method, which yielded similar results as the TNMM. The EC assessed this method to be unjustified.

McDonald's

The Commission is currently investigating whether fast food chain McDonald's was the recipient of State aid by Luxembourg[139]. The APA in question applies to McD Europe Franchising SARL (McD Europe). This subsidiary is established in Luxembourg and has two branches, the US Franchise Branch and the Swiss Service Branch. McD Europe acquired franchising rights from US group members via a buy-in payment and entering into a CSA.

The franchising rights were assigned to the US Franchise Branch. The Swiss Service Branch licensed these franchising rights to various franchisors throughout several European countries. The royalties received were paid to the US Franchise Branch after deducting a service fee based on a cost plus method.

The Luxembourg unilateral tax ruling acknowledges that the branches are permanent establishments under the double tax treaties. The income related to activities of the branches is therefore exempt of corporate income tax in Luxembourg. McDonald's informed the Luxembourg tax authorities that the US Franchise Branch was not considered to constitute a US trade or business under US tax rules. As a consequence, the income of the US Franchise Branch remains untaxed in both Luxembourg and the US.

IKEA

Recently the EC launched an investigation into potential State aid to furniture retailer IKEA by the Netherlands[140]. IKEA is split into two separate groups. INGKA Group is the main retailer that owns the stores, whereas Inter IKEA owns the franchise rights to the concept[141]. INGKA Group pays a franchise fee equal to 3% of revenues.

All franchise fees are collected by Dutch subsidiary Inter IKEA Systems BV (Systems). From 2006 until 2011, Systems paid an annual license fee to its sister company I.I. Holding in Luxembourg. The fee remained untaxed under a special tax regime in Luxembourg for holding companies. After Luxembourg was forced by the EC to abandon the regime, Systems

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[139] State aid - Luxembourg - State aid SA.38945 (2015/C) (ex 2015/NN) - Alleged aid to McDonald's - Invitation to submit comments pursuant to Article 108(2) of the Treaty on the Functioning of the European Union, *OJ* 15 July 2016, C258, 11-48.

[140] Letter to the Member State (EC). State aid SA.46470 (2017/NN) - Netherlands - Possible State aid in favour of Inter IKEA, 18 December 2017, C(2017) 8753 final.

[141] In May 2016, IKEA has restructured the group. The franchising principle between IKEA Group and Inter IKEA remains unchanged.

purchased the intangible property. This was financed by an intercompany loan from its parent company based in Liechtenstein. The Commission is assessing whether the past license fee, the acquisition price for the intangible property and the intercompany interest are priced at arm's length.

Argumentation of the EC

To prove the existence of State aid, the EC recognises, with reference to CJEU jurisprudence, all four elements of art. 107 § 1 TFEU have to be fulfilled[142]. These conditions are the following.

i. The aid should be granted by a Member State or through State resources.
ii. It must distort or threaten to distort competition.
iii. The measure favours certain undertakings or the production of certain goods.
iv. It affects trade between Member States.

The Commission refers to CJEU jurisprudence to establish that the lowering of the tax liability by the Member State constitutes State aid, as it puts the recipient in a more favourable financial position than its competitors[143].

By reducing the tax liability of the taxpayer by means of the APA, the competitive position of the company is improved relative to other undertakings. Based on CJEU judgment, the EC concludes that this distorts or threatens to distort competition[144].

The existence of a selective advantage is upheld by the finding that the tax ruling endorses a non-arm's length approach. The APA favours an individual undertaking and places it outside the legal reference framework[145].

The tax ruling is liable to affect the intra-EU trade, since the subject of the APA is part of a multinational group that is active in all Member States of the EU[146].

[142] Commission Decision (EU) 2017/502 of 21 October 2015 on State aid SA.38374 (2014/C ex 2014/NN) implemented by the Netherlands to Starbucks, *OJ* 29 March 2017, L83, (38) 78, no. 224.
[143] *Ibid.*, no. 226.
[144] *Ibid.*, 79, no. 227.
[145] *Ibid.*, 110, no. 416.
[146] *Ibid.*, 78, no. 227.

Considerations on the EC's argumentation

Where the OECD provides guidance on how the tax authorities can fight BEPS, the EC is limited to investigating State Aid offered by Member States. The OECD and the Commission start from opposing viewpoints.

The EC began targeting APAs issued by the Member States only relatively recently. The argumentation has been challenged and is yet to be judged by the CJEU, where several parties have appealed the decisions.

The value of an APA

Under the OECD's guidance, APAs would cover the assumptions made to determine the value and transfer pricing of the HTVI. As HTVI hold uncertainties also for the taxpayer, the OECD recognises that the guidance is not applicable when the transaction is covered by a bilateral or multilateral APA. This approach provides legal certainty to the taxpayer. The EC is challenging tax rulings issued by Member States, albeit so far only unilateral APAs. In its assessment, the EC decides that compensation for certain group members are not at arm's length, because it disagrees with the functions performed as identified in the APA. In hindsight, the Commission can disagree with the assumptions and analyses made in the transfer of an HTVI, as documented and validated in an APA.

The Commission recalls, based on CJEU judgment, that it is not bound by its decisional-practice[147]. As such, the EC seemingly claims the right to abandon consistency between past and future decisions. This further erodes the legal certainty a taxpayer can achieve by requesting an APA.

Scope of an APA

Member States and taxpayers will face difficulties in concluding to which extent the transfer of an HTVI is covered by an APA. This ambiguity applies both to the legal entities involved as well as to the scope of transactions that are subjected to investigation. The argumentation of the Commission lacks consistency in that matter.

Several legal entities together form an undertaking, if they are an economic unit for the purpose of the subject-matter of the agreement, according to CJEU judgment[148]. The EC

[147] *Ibid.*, 81, no. 239.

[148] CJEU 12 July 1984, no. C- 170/83, ECLI:EU:C:1984:271, pt. 11. The CJEU ruling referred by the EC concerned associated entities operationally acting as a whole.

interpreted this statement so that State aid benefits the corporate group as a whole[149]. This conclusion conflicts with the Commission's own argument towards Fiat that the advantage derived from the APA has to be assessed on the individual entity level[150].

When evaluating the fairness of tax rulings, the EC not only assesses what has been confirmed, but also what was not covered. In the Starbucks investigation, the Commission argues the sale of green beans from the Swiss sister company to SMBV is in scope of the APA, although not mentioned therein[151]. If the transfer of HTVI is covered by an APA, all related intercompany transactions are in scope of a possible investigation. Such transaction may be indirectly related and not obviously connected. A third group member providing intercompany financial services can provide certain services, for example the valuation of the HTVI, under a service agreement. This agreement may or may not be in scope of the APA, subject to the EC's appraisal.

On the other hand, the EC dismisses the reference to arrangements between group members if that relationship is not covered by the APA. Alki LP paid royalties onwards to US group members that were of the same order of magnitude as the ones it received. This relationship was deemed irrelevant[152]. The ultimate beneficiary of the value that is created is not taken into account. Similarly, in the Apple investigation, the Commission accepts the CSA terms at face value and challenges the profit allocation under the APA. The ALP would, based on economic substance, allocate the intangibles to US group members rather than the Irish branches[153].

The OECD requires that the remuneration for intangibles under the ALP are in line with the functions performed, risks assumed and assets used by the different group members[154]. If not all group members that contribute to the intangible are taken into account, the functional analysis is not properly performed. The adequate remuneration can consequently not be

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[149] Commission Decision (EU) 2016/2326 of 21 October 2015 on State aid SA.38375 (2014/C ex 2014/NN) which Luxembourg granted to Fiat, *OJ* 22 December 2016, L351, (1) 61, no. 342-344.
[150] *Ibid.*, 56, no. 314. This is in line with the CJEU's stance about the separateness of the legal entities. *Supra*, 32, fn. 122.
[151] *Supra*, 35, fn. 133.
[152] Commission Decision (EU) 2017/502 of 21 October 2015 on State aid SA.38374 (2014/C ex 2014/NN) implemented by the Netherlands to Starbucks, OJ 29 March 2017, L83, (38) 96, no. 334.
[153] S. D. FELGRAN and M. HUGHES, "Transfer Pricing Meets State Aid: Conflicting Arm's-Length Standards and Other Lessons From the Apple Saga", *TNI* 2017, (959) 970.
[154] *Supra*, 15, fn. 56.

determined. The Commission only regards selected transactions involving entities subject to an APA issued by a Member State.

Ex post outcome

The EC assesses whether an APA de facto grants an advantage to the requester. The ex post outcome can serve as a presumption for the consistency with the ALP, as intended by the OECD for HTVI. The Commission claims that it builds on the ALP as put forth in the OECD guidelines to assess whether a selective advantage exists. Critics have argued that the Commission should start from the national law instead[155]. This point had also been raised by Luxembourg in the Fiat case[156].

In response, the EC states it does not compare the tax treatment of FFT with that of other companies in comparable situations in Luxembourg[157]. With that statement, the EC implicitly defies the competence of the Member States in direct taxation. The Commission's approach to challenge APAs in general can be considered to undermine the fiscal sovereignty in direct tax of the Member States[158]. Bilateral APAs between Member States could consequently be exposed to investigation by the EC. This would defy the purpose of the APA, which is recognised by the OECD's guidance on HTVI.

The Commission challenged the price adjustment clause included in the sale of the intangible property by Systems in the IKEA investigation. The EC confirms the OECD statement that uncertainty in itself is insufficient as justification to include a price adjustment clause[159]. Such clause should not be included without analysing what independent enterprises would have agreed.

Consistency

The US Department of the Treasury questions whether the EC applies the ALP at all, accusing the EC of deviating from the internationally agreed consensus on the ALP[160]. As the Commission considers the ALP to be inherently part of art. 107 § 1 TFEU, this constitutes a

[155] A. GUNN and J. LUTS, "Tax Rulings, APAs and State Aid: Legal Issues", *EC Tax Review* 2015, (119) 122.
[156] Commission Decision (EU) 2016/2326 of 21 October 2015 on State aid SA.38375 (2014/C ex 2014/NN) which Luxembourg granted to Fiat, *OJ* 22 December 2016, L351, (1) 27, no. 148.
[157] *Ibid.*, 28, no. 151.
[158] E. FORT, "EU State Aid and Tax: An Evolutionary Approach", *European Taxation* 2017, (370) 382.
[159] Letter to the Member State (EC). State aid SA.46470 (2017/NN) - Netherlands - Possible State aid in favour of Inter IKEA, 18 December 2017, C(2017) 8753 final, 61, no. 207. Reference is made to the 2010 TPG.
[160] US DEPARTMENT OF THE TREASURY, "The European Commission's Recent State Aid Investigations Of Transfer Pricing Rulings", 2016, www.treasury.gov/resource-center/tax-policy/treaties/Documents/White-Paper-State-Aid.pdf, 19.

different standard than the ALP based on art. 9 of the OECD model convention. The Treasury Department is concerned that the EC deviated from the TPG in its assessments.

The Treasury Department also criticised the lack of consistency in the EC's decisions. The Commission adopted a new approach to confirm the existence of a selective advantage. The Department challenges the fact that in all past investigations into State aid, the existence of an advantage and the existence of selectivity were treated as distinct elements[161]. The observation has been made that collapsing the two criteria was contrary to both CJEU case law and the law on State Aid[162].

In the decisions concerning the individuals APAs, arrangements that are considered not to be at arm's length immediately are categorised as constituting a selective advantage. In its own defence, the Commission refers to CJEU case law[163]. The Court stated that in individual cases, as opposed to general aid schemes, the existence of an advantage is in principle sufficient to support the presumption of selectiveness[164].

In the Commission's historical approach, an APA reducing the administrative burden would not be considered State aid. The company would get an advantage, however not at the cost of State resources. Under the collapsed approach, such advantage would be sufficient to constitute State aid[165]. The transfer of HTVI covered by a bilateral APA would not be subject to additional scrutiny based on the ex post profits related to that HTVI. The taxpayer is relieved from a potentially onerous administrative burden. The existence of such an APA could in itself be considered as State aid under the EC's current approach.

While formally upholding the justification referring to CJEU jurisprudence on individual cases, the Commission has also separately assessed the selectivity in its most recent publications, the decision with recovery on Amazon[166] and the letter initiating the

[161] *Ibid.*, 8.
[162] E. FORT, "EU State Aid and Tax: An Evolutionary Approach", *European Taxation* 2017, (370) 382.
[163] State aid - Luxembourg - State aid SA.38945 (2015/C) (ex 2015/NN) - Alleged aid to McDonald's - Invitation to submit comments pursuant to Article 108(2) of the Treaty on the Functioning of the European Union, *OJ* 15 July 2016, C258, (11) 26, no. 75.
[164] CJEU 4 June 2015, no. C-15/14 P, ECLI:EU:C:2015:362, pt. 60.
[165] E. FORT, "EU State Aid and Tax: An Evolutionary Approach", *European Taxation* 2017, (370) 376.
[166] Commission Decision (EC) of 4.10.2017 on State aid SA.38944 (2014/C) (ex 2014/NN) implemented by Luxembourg to Amazon, 4 October 2017, C(2017) 6740 final, 97, no. 400 and 159-166, no. 580-605.

investigation into IKEA[167]. Implicitly the EC acknowledges the criticism on the collapsing the existence of an advantage with that of selectivity.

Audit term

The value of HTVI is highly uncertain at the time of transfer. The information asymmetry between the taxpayer and the tax administration poses an additional challenge on the latter. For this reason, the OECD allows the tax authorities to use the ex post outcome as presumptive evidence on the appropriateness of the transfer pricing. This actual outcome often realises only years after the transfer, outside of the tax audit period. Investigations into possible State aid are limited to a period of ten years[168]. This places the EC in a position to evaluate APAs using the ex post outcome, whereas the Member States suffer from the information asymmetry at the moment of issuance of the APA.

Conclusion

The OECD tries to achieve a balance between the taxpayer and the tax authorities, by addressing the information asymmetry. As a third player in the field, the EC threatens to disrupt such balance. Tax authorities themselves are subjected to inquiries into the appropriateness of the ex ante pricing. The starting position of the Commission is completely contrary to that of the OECD. Where the OECD issues guidance to support the tax authorities, the EC seeks to challenge rulings that are in its opinion unfairly awarded by those tax authorities.

HTVI by their very nature can produce outcomes that differ from the initial forecasts. The actual profit split between group members can deviate from the envisioned equilibrium. APAs can no longer be relied upon by the taxpayer. If the EC judges that the outcome is not in line with the ALP, State aid recovery will be demanded.

APAs could even become a liability, rather than an asset for a company. The Commission has demonstrated a high degree of inconsistency in how related transactions are taken into account. Arrangements indirectly related to the APA can be assessed, taken at face value or completely ignored by the EC. As a result, the safe harbour for HTVI that the OECD identified in bilateral or multilateral APAs is completely eroded.

[167] Letter to the Member State (EC). State aid SA.46470 (2017/NN) - Netherlands - Possible State aid in favour of Inter IKEA, 18 December 2017, C(2017) 8753 final, 34, no 109 and 64-68, no. 219-236.
[168] Art. 15 Council Regulation no. 659/1999, 22 March 1999 laying down detailed rules for the application of Article 93 of the EC Treaty, *OJ* 27 March 1999, L83, 1.

UNITED STATES

The United States have extensive regulations on the ALP and methods to determine the appropriate transfer pricing. Intangibles have received special attention under these regulations. The US regulations have served as a model for some of the guidance by the OECD, including that on HTVI.

Legislation

The Internal Revenues Code (IRC) is the US federal tax law. It is enacted in Title 26 of the United States Code (26 USC). The US Department of the Treasury provides the official interpretation of the IRC in the Treasury Regulations, which are published in Title 26 of the Code of Federal Regulations (Treas. Reg. or 26 CFR)[169].

Intangibles

The term intangible property is defined in 26 USC § 936(h)(3)(B) as "any

i. patent, invention, formula, process, design, pattern, or know-how;
ii. copyright, literary, musical, or artistic composition;
iii. trademark, trade name, or brand name;
iv. franchise, license, or contract;
v. method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data;
vi. any goodwill, going concern value, or workforce in place (including its composition and terms and conditions (contractual or otherwise) of its employment); or
vii. any other item the value or potential value of which is not attributable to tangible property or the services of any individual."

[169] INTERNAL REVENUE SERVICE (IRS), "Tax Code, Regulations and Official Guidance", www.irs.gov/ privacy-disclosure/tax-code-regulations-and-official-guidance (consultation on 26 December 2017).

The definition of intangibles in 26 USC § 936(h)(3)(B) has been updated by the US Tax Cuts and Job Act[170]. Treas. Reg. § 1.482-4(b) defines intangibles for the purpose of section 482 using the previous wording of section 936. This definition omits goodwill, going concern value, or workforce. The previous definition in section 936 included a catch-all phrase for "similar items", without further elaboration. Treas. Reg. § 1.482-4(b)(6) specifies that "an item is considered similar […] if it derives its value not from its physical attributes but from its intellectual content or other intangible properties". It can be expected that the regulations will be aligned to the USC.

The legal owner of intangible property is considered to be the owner for tax purposes, unless the legal ownership is inconsistent with the economic substance of the underlying transactions[171].

Joint development

Under a cost-sharing arrangement (CSA), each participant engages to share the intangible development cost in proportion to their shares of reasonably anticipated benefits. A CSA is similar to a CCA under the OECD TPG, under which HTVI can be developed. Each participant that makes a platform contribution receives an arm's length compensation by each of the other participants. A platform contribution is any resource, capability, or right to advance the development of the cost shared intangibles[172].

Payments for platform contributions can be under the form of a lump sum, or payments contingent on the exploitation of the intangible. Contingent payments must be at arm's length. The conditions under which a contingent payment would be required must be clearly specified. The IRS will only respect such provision if consistent with economic substance[173].

Transfer price methods

To establish the arm's length price for an intangible, the regulations list four methods available to taxpayers to determine the arm's length pricing of intangibles. These methods are

i. the comparable uncontrolled transaction (CUT) method;
ii. the comparable profits method (CPM);
iii. the profit split method; and

[170] An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018, Pub. L. 115-97, *Stat.* 22 December 2017, 2054, § 14221.
[171] Treas. Reg. § 1.482-4(f)(3)(i)(A).
[172] Treas. Reg. § 1.482-7(a)-(e).
[173] Treas. Reg. § 1.482-7(h)(2).

iv. unspecified methods.

The CUT method is similar to the CUP method of the TPG[174]. Equivalent to the TNMM in the TPG, the CPM establishes the transfer price by determining the appropriate operating profit[175]. The CUT and CPM method are, due to their nature, not suitable for the valuation of HTVI.

The profit split method determines the arm's length split of combined profits from the transaction. The method is equal to the transactional profit split method of the TPG[176]. This method can be applicable when transferring HTVI.

The regulations allow for unspecified methods to be used, as long as the general principles to determine an arm's length result[177].

To value the platform contribution under a CSA, the regulations list the following three additional valuation methods[178].

i. The income method;
ii. The acquisition price method; and
iii. The market capitalisation method.

The income method determines the present value of the best alternative to the contribution of the intangible. It is a two-sided method similar to the relief-from-royalty method. Under the acquisition price method, the value of an intangible is estimated by assessing the acquisition of an undertaking, or part thereof, involving comparable intangibles. Similarly, the market capitalisation method adjusts the market capitalisation of regularly traded companies holding similar intangible property. Under the two last methods, corrections are made to exclude the value of tangible assets and unrelated intangibles.

Commensurate with income standard

The Tax Reform Act of 1986[179] overhauled the US tax system in one of the most comprehensive manners since its inception[180]. The intercompany transfer of intangibles was

[174] Treas. Reg. § 1.482-4(c).
[175] Treas. Reg. § 1.482-5(b).
[176] Treas. Reg. § 1.482-6.
[177] Treas. Reg. § 1.482-4(d).
[178] Treas. Reg. § 1.482-7(g)(4)-(6).
[179] Tax Reform Act of 1986, Pub. L. 99-514, *Stat.* 22 October 1986, 2085.
[180] JOINT COMMITTEE ON TAXATION, *General Explanation of the Tax Reform Act of 1986*, 4 May 1987, Washington, US Government Printing Office, 1987 and www.jct.gov/jcs-10-87.pdf, 6.

specifically addressed. Congress recognised the incentives for corporations to shift intangibles to low-tax jurisdictions. Tax on the associated income could be deferred indefinitely. The ALP was found to be inadequate to prevent abuse in the absence of comparable arrangements. Congress judged this problem to be particularly acute for the transfer of high-profit-potential intangibles still in early stage of development[181]. Congress clearly aimed to address HTVI.

The intent of Congress was to ensure high-profit intangible property would be transferred at above-average compensation. To this end, not only the information available at the time of transfer of the intangible was taken into account to establish the appropriate transfer price. The actual income attributable to the intangible was intended to be taken into account[182]. The Tax Reform Act of 1986 therefore introduced the commensurate-with-income (CWI) standard in sections 367 and 482 of the Internal Revenue Code[183].

This CWI standard, dubbed the super-royalty provision, was criticised from its inception to depart from the ALP[184]. The Treasury Department and the IRS on the other hand consider the CWI principle to be consistent with the ALP[185].

Internal Revenue Code

26 USC § 482 empowers the US tax authorities, the Internal Revenue Service (IRS), to allocate income and deductions among taxpayers in intercompany transactions to pre-empt tax evasion. Specifically for the transfer or license of intangibles, the section states that "the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible". Section 482 is an instrument exclusive to the IRS. The taxpayer cannot invoke the provision, or compel the IRS to invoke it. In case the IRS makes a correction based on section 482, the taxpayer carries the burden to proof the adjustment is arbitrary, capricious or unreasonable[186].

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[181] *Ibid.*, 1013-1014.

[182] *Ibid.*, 1016.

[183] Tax Reform Act of 1986, Pub. L. 99-514, *Stat.* 22 October 1986, 2085, § 1231(e).

[184] Y. BRAUNER, "Value In The Eye Of The Beholder: The Valuation Of Intangibles For Transfer Pricing Purposes", *Va. Tax Rev.* 2008, (79) 101; E. C. LASHBROOKE, JR., "I.R.C. § 482 Commensurate With Income Standard For Transfers Of Intangibles", *DePaul Bus. L. J.* 1989, (173) 191; M. M. LEVEY and S. C. RUCHELMAN, "Section 482 - The Super Royalty Provisions Adopt The Commensurate Standard", *Tax Lawyer* 1988, (611) 611.

[185] Treas. Reg. § 1.482-4(f)(2); INTERNAL REVENUE SERVICE (IRS), "Treatment of Services Under Section 482; Allocation of Income and Deductions From Intangibles; and Apportionment of Stewardship Expense", *FR* 4 August 2006, (44466) 44478.

[186] C. H. GUSTAFSON, R. J. PERONI and R. C. PUGH, *Taxation of International Transactions: Materials, Texts And Problems*, St. Paul, West Publishing Co., 2011, 713.

A similar provision is included in 26 USC § 367(d)(2)(A)(ii). Section 367 covers the transfer of property by a US person to a foreign entity in exchange of shares or qualifying securities. The transfer of intangible property under this section will be treated as if it was sold "in exchange for payments which are contingent upon the productivity, use, or disposition of such property". The payments are deemed to be received annually over the useful life of the asset, commensurate with the income attributable to the intangible.

Code of Federal Regulations

Treas. Reg. § 1.482-4(f)(2) enable the IRS to make periodic adjustments to ensure the transfer price of an intangible is commensurate with the income attributable to the intangible. The remuneration can be revisited in each year, regardless of whether the year of the original transfer is still open under the statute of limitation.

Periodic adjustments will not be made if the conditions for exception are met[187]. In case the same intangible has been transferred to an uncontrolled party under substantially the same circumstances at the same price, no adjustment will be made to the controlled transaction.

The regulations include safe harbour provisions. If the transfer price was determined based on the transfer of comparable intangible property between independent parties, no adjustment is made provided all of the following conditions are met.

i. The written agreement covering the transaction included a remuneration for the intangible that was at arm's length in the first taxable year in which a substantial payment occurred.
ii. The written agreement of the comparable transaction relied upon to establish the transfer pricing contains no price adjustment, renegotiation or termination clauses applicable to the circumstances of the controlled transaction.
iii. The term during which the agreement is effective is similar to that of the independent transfer.
iv. Use of the intangible is limited by the agreement in line with industry practice and the uncontrolled agreement.
v. The functions performed by the transferee did not substantially change, except as a result of unforeseeable events.
vi. The cumulative benefits from the exploitation of the intangible up to and including the year under review are within 80% to 120% of the forecast.

[187] Treas. Reg. § 1.482-4(f)(2)(ii).

If any other method than the CUT method is used to establish the appropriate transfer price, no adjustment will be made if all of the following four conditions is fulfilled.

i. A written agreement is in place that determines an annual remuneration.
ii. The remuneration was at arm's length in the first taxable year in which a substantial payment occurred, duly documented at the time of transfer.
iii. The functions performed by the transferee did not substantially change, except as a result of unforeseeable events.
iv. The cumulative benefits from the exploitation of the intangible up to and including the year under review are within 80% to 120% of the forecast.

If the conditions under either method are met for five consecutive years, no periodic adjustments will be made in any subsequent year.

The periodic adjustments will also not be made, under either method, if the cumulative benefits fall outside the 80%-120% bandwidth due to extraordinary events and all other conditions are satisfied. Such events are beyond the taxpayer's control and cannot reasonably have been anticipated at the time of entering into the agreement.

Advance Pricing Agreements

The process for APAs in the US is defined in the Revenue Procedures of the IRS[188]. APAs are advance rulings specific for transfer pricing purposes, which are binding on both tax authorities and taxpayer[189]. An APA can be issued for transactions that have already taken place, as long as the taxable year is still open under statute of limitation rules.

The IRS has the ability to cancel an APA in case of fraud, a material misrepresentation or mistake, critical change in legislation or jurisprudence, or failure of a critical assumption[190]. The US Tax Court has ruled that the APA is a binding agreement that cannot be revoked at the sole discretion of the IRS[191].

[188] Rev. Proc. 2015–41, *IRB* 2015-35, 263.
[189] See also C. S. TRIPLETT and J. C. MALONEY, "Advance Rulings in the United States", *Bull. for Int. Taxation* 2001, 407-416.
[190] Rev. Proc. 2015–41, *IRB* 2015-35, 263, § 7.06(1)-(3).
[191] US Tax Court 26 July 2017, T.C. Memo. 2017-147, Eaton Corp. v. Commissioner, www.ustaxcourt.gov, 193.

Since the start in 1991 through 2017, 66% of the APAs executed were bilateral or multilateral[192]. In the past five years, this number was 76%. In 2017, over 20% of the transactions covered by the APA involved intangibles[193].

Case law

Court opinions have caused the Treasury and IRS to adjust the regulations on more than one occasion. The US Tax Court has not always validated the Treasury Regulations.

R.T. French Co.

Prior to the introduction of the CWI standard, US case law prohibited the use of hindsight in evaluating the appropriateness of the transfer pricing of intangibles. This was established in the case of food manufacturer R.T. French Company. The tax authorities had challenged royalty payments at the end of a 20-year licensing agreement between associated enterprises. The US Tax Court ruled that the actual results of two tax years at the end of the agreement period could not serve as indications for the arm's length royalty amount[194].

Bausch & Lomb

Bausch & Lomb, Inc. (B&L) is a contact lens manufacturer that was accused of improperly licensing production know-how to its Irish subsidiary, Bausch & Lomb Ireland, Ltd. The know-how enabled the plant to obtain significantly lower production costs compared to other manufacturing processes. A significant portion of the production of the Irish subsidiary was sold to the parent company. The IRS argued the intangible license agreement and intercompany sales of lenses should be collapsed to a contract manufacturing agreement. The US Tax Court stated the IRS should respect the transaction as structured[195]. The Court found the actual profits realised by B&L Ireland to be irrelevant, since this information was not available at the time of the intercompany transaction[196].

It was not guaranteed that the US parent would buy production from the Irish subsidiary, nor was there any guarantee about the transfer price. The Court recognised the argument would have had merit if there would be an obligation by the parent company to buy the production.

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[192] INTERNAL REVENUE SERVICE (IRS), "Announcement And Report Concerning Advance Pricing Agreements", 2018, www.irs.gov/pub/irs-drop/a-18-08.pdf, 4.
[193] *Ibid.*, 8.
[194] US Tax Court 6 September 1973, R. T. French Company v. Commissioner, *T.C.* 1973, (836) 854.
[195] US Tax Court 23 March 1989, Bausch & Lomb, Inc. v. Commissioner, *T.C.* 1989, (525) 583-584.
[196] *Ibid.*, 601.

In itself, the Court does not oppose adjustments of the arrangements. Changes to pricing arrangements as proposed under the OECD guidance on HTVI may thus be warranted.

Xilinx

Chip developer and manufacturer Xilinx Inc. had entered into a CSA with its subsidiary Xilinx Ireland, an unlimited liability company incorporated in Ireland. The bulk of the R&D was performed by the US parent. Stock options given to employees as compensation were not included in the development costs to be shared. The IRS challenged this approach, as this would cause the US parent to incur costs in excess of its share of reasonably expected benefits.

Petitioner and respondent agreed independent undertakings would not share a cost linked to the stock price of any participant. The IRS argued this did not apply in dealings between associated enterprises. The Court followed Xilinx' reasoning that these costs should be excluded from the CSA according to the ALP, as independent parties would do the same.

In its argumentation, the IRS stated the CWI standard replaced the ALP. The Court rejected this notion, saying "the commensurate-with-income standard was intended to supplement and support, not supplant, the arm's-length standard"[197].

The Court of Appeal had reversed the Tax Court's decision[198], but has later withdrawn its opinion[199]. Ultimately, the Court of Appeal affirmed the Tax Court's judgment[200].

Veritas Software

Software developer Veritas Software Corporation has set up a CSA with its newly established Irish subsidiary. The US parent contributed intangible property, including trademark, patents and source code. This platform contribution was valued using the CUT method at $118 million, paid as lump sum. The IRS challenged the method and replaced it by the CPM. Using a discounted cash flow (DCF) model, the buy-in was valued at $1.7 billion. The Court judged the valuation by the IRS as arbitrary, capricious, and unreasonable.

The IRS had applied a different valuation method, claiming without grounds the contribution was akin to a sale. It had further applied an incorrect discount rate and growth rate. Lastly, the

[197] US Tax Court 30 August 2005, Xilinx Inc. v. Commissioner, *T.C.* 2005, (37) 56-57 and www.ustaxcourt.gov.
[198] 9th Cir. 27 May 2009, Xilinx, Inc. v. C.I.R., *F.3d* 2009, 482.
[199] 9th Cir. 13 January 2010, Xilinx, Inc. v. C.I.R., *F.3d* 2010, 1017.
[200] 9th Cir. 22 March 2010, Xilinx, Inc. v. C.I.R., *F.3d* 2010, 1191.

useful life of the intangible that were contributed was assumed to be perpetual rather than the more appropriate estimate of four years[201].

Altera

In a case similar to Xilinx, another chip developer and manufacturer, Altera Corporation, had set up a CSA with its subsidiary Altera International, a Cayman Islands corporation. Compensatory stock options (CSO) were not included in the CSA cost base. Treas. Reg. § 1.482-7(d) had in the meantime been updated, stating that the CSA should include CSO. The preamble to the regulation argued CSA should be compliant with the CWI standard, in order to be consistent with the ALP[202]. The US Tax Court disregarded the updated regulations. It concluded the interpretation by the Treasury Department of the CWI standard did not provide sufficient basis for the updated regulations[203]. The Court consequently judged consistently with its earlier opinion from the Xilinx case.

Medtronic

Medical technology company Medtronic, Inc. licensed technology and know-how to its subsidiary in Puerto Rico. The Court dismissed the IRS' demand to substitute the CUT method used by Medtronic by the CPM, to achieve an outcome that satisfied the CWI standard[204].

Amazon

Online retailer Amazon.com, Inc. entered into a CSA with its Luxembourg subsidiary, Amazon Europe Technologies Holding SCS (Lux SCS). The buy-in payment by Lux SCS for website technology contributed by the US parent amounted to $254.5 million, paid in instalments over several years. The IRS valued the platform contribution at $3.5 billion, using a DCF model rather than Amazon's CUT method. Presented with similar facts, the Court judged the case nearly identical to Veritas Software[205].

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[201] US Tax Court 10 December 2009, Veritas Software Corp. & subs. v. Commissioner, *T.C.* 2009, 297 and www.ustaxcourt.gov.

[202] INTERNAL REVENUE SERVICE (IRS), "Compensatory Stock Options Under Section 482", *FR* 26 August 2003, (51171) 51172.

[203] US Tax Court 27 July 2015, Altera Corp. v. Commissioner, *T.C.* 2015, (91) 122 and www.ustaxcourt.gov.

[204] US Tax Court 9 June 2016, T.C. Memo. 2016-112, Medtronic, Inc. v. Commissioner, www.ustaxcourt.gov, 120.

[205] US Tax Court 23 March 2017, Amazon.com, Inc. v. Commissioner, www.ustaxcourt.gov.

Reconciling HTVI with US regulations

The CWI standard clearly served as a basis for the OECD guidance on HTVI. The impact of the new TPG will be little to non-existent for US companies and dealings with them. Overall, the US rules seem more stringent than the HTVI guidance. The US experience can shed some light on how HTVI will be treated under the new OECD guidance.

Comparing OECD and US rules

Despite the fact that the US regulations served as a basis for the OECD guidance, a few differences exist. A first difference is in the scope of the rules. The OECD issued guidance that is only applicable for hard-to-value intangibles. The US tax regulations are applicable to all intangible property.

At the time when the CWI standard was introduced, the OECD has made some reservations. The use of hindsight includes a risk of violating the ALP, as the assessment of the transfer pricing should consider the facts and circumstances that governed the transaction at the moment it took place[206]. There would be no breach of the ALP if the application of the provision would be limited to profits that were predictable or foreseeable at the time of the intra-group transfer. The OECD found that US regulations conflicted with the ALP, where they exclude transactions from the safe harbour rules for the sole reason that the actual profits are outside the 80%-120% bandwidth around the projections[207].

The guidance on HTVI is not applicable if any of four conditions is met[208].

i. The taxpayer provides details on the ex ante forecasts, including adequate reflection of risks and foreseeable events. He further provides evidence that any significant deviations from the projections are due to unforeseeable events or the playing out of risks that were taken into account.
ii. The transactions are covered by a bilateral or multilateral Advance Pricing Arrangement (APA).
iii. Any adjustments based on the ex post outcome would not alter the transfer price by more than 20%.

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[206] OECD, "Intercompany Transfer Pricing Regulations Under US Section 482 Temporary And Proposed Regulations", 1993, OCDE/GD(93)131, www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=OCDE/GD(93)131&docLanguage=En, 5-6, no. 2.5.
[207] *Ibid.*, 11, no. 2.28.
[208] *Supra*, 10.

iv. A commercialisation period of five years has elapsed since the HTVI first generated revenues from third parties. For that period, no significant differences between the projections and the actual outcomes, exceeding 20% of projections, have arisen.

These conditions are less stringent than the US conditions, despite the clear similarities. The Treasury Regulations require all conditions to be fulfilled, as opposed to any one of them under the OECD guidelines. The sole fact that actual profits that differ greatly from the forecasts does not preclude the transaction to be released from the application of the HTVI guidance, if any of the other conditions applies.

Under the US regulations, the compensation paid during the first year with substantial payments is always required to be at arm's length. No safe harbour rules or exceptions can apply. In some cases, HTVI first undergo further development before commercialisation. Depending on the terms of the intercompany licensing, the first substantial payment may be several years down the road. The CWI standard can be applied regardless.

Tolerance bandwidth

Both OECD guidelines and US regulations include an 80%-120% bandwidth of tolerance, but with subtle differences. For US purposes, the bandwidth is applicable on the profits or cost savings attributable to the intangible. Under OECD guidelines, no adjustment will be made if the adjustment based on the ex post outcome would not exceed 20% of the compensation for the HTVI.

Example

A pharmaceutical company develops a new drug. The patent fulfils the criteria to classify as an HTVI. A foreign subsidiary licenses the formula to service a particular geographical area.

Ex post, sales have been underestimated by 15%. Due to economies of scale, profits are 25% higher than anticipated. The royalty rate is set per value of sale. Tax authorities estimate an arm's length pricing warrants a 15% increase of the royalty rate. This agreement is subject to adjustments under the CWI standard, and will not be amended under the HTVI guidance.

Unforeseeable and extraordinary events

The US regulations prescribe that functions performed can change due to unforeseeable events. Actual results outside the 80%-120% tolerance are not subject to adjustments if caused by extraordinary events. Under OECD guidance, unforeseeable events causing

significant deviations from the forecast can exonerate taxpayers from transfer pricing adjustments.

These conditions are similar, but not the same. A hurricane severely damaging production plants in Texas, can be considered extraordinary. Given the frequency of hurricanes in Texas, is such occurrence also unforeseeable? Or does the OECD expect taxpayers to include such scenarios in the probability weightings, with a low likelihood assigned to the occurrence?

Five years term

Both the OECD and the US Treasury include a five year mark, after which no adjustments will be made. Under the OECD guidelines, these five years start after the first commercial third party results of the intangible. US regulations start counting from the first significant intercompany payment. If an HTVI is transferred between associated enterprises, the transferee may still further develop the intangible for several years before commercialisation. If the transfer involves a significant upfront payment, the US five year term may have ended before the OECD's five year term has started.

In practice

The CWI standard is rarely used in practice[209]. The standard is meant to be applied consistently with the ALP, despite the IRS occasionally claiming otherwise. The use of hindsight under the super-royalty provision departs from the ALP, making the standard obsolete for practical purposes. The approach for HTVI is also intended to be consistent with the ALP[210]. The experience in the US suggests this may be hard to bring into practice. The interpretation of the CWI standard by the Treasury is, even when formalised in regulations, not always followed by the Court.

The OECD guidance on HTVI may be implemented by a range of countries. The practical application may conflict with the ALP in specific cases. The use of the ex post benefits derived from the intangible must not equal the use of hindsight without taking into account the information available at the time of transfer of the HTVI. The scope of the CWI standard is still a subject for debate in the US. The HTVI guidance by the OECD may spur similar discussions upon implementation.

[209] M. L. SCHLER, "The Arm's-Length Standard After Altera and BEPS", *TN* 2015, (1149) 1155; Y. BRAUNER, "Cost Sharing and the Acrobatics of Arm's Length Taxation", *Intertax* 2010, (554) 565.
[210] *Supra*, 15, fn. 52.

OTHER COUNTRIES

A few countries already have regulations in place that resemble aspects of the OECD guidance on HTVI. Notably Canada and Germany have adopted measures that display similarities.

Canada

The tax authorities have introduced guidance on the pricing arrangements of intangibles in 1999 via an Information Circular[211]. Taxpayers must consider contingent payment arrangements for intangibles if independent parties would include those. According to the circular, licensors would consider a relatively short contract term, a price adjustment clause, or variable royalties depending on profits[212].

Tax authorities have the right to adjust the pricing arrangements under long-term contracts, if those are not in line with what independent parties would have agreed. This is targeted specifically to cases where an intangible is transferred under a lump sum payment, or where the licensee has an unrestricted entitlement of the rights to the intangible property arising from ongoing research[213]. This provision is similar to the OECD view on contingent payment arrangements for HTVI. The same reservations can consequently be made, about whether independent parties would indeed so readily agree to contingent payment provisions as assumed by the regulator.

The Canadian approach is based on the ALP and differs from the CWI standard. The use of hindsight is not allowed. Transfer pricing is not subject to adjustments based on the occurrence of subsequent events[214].

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[211] IC 87-2R, 27 September 1999, www.canada.ca.
[212] *Ibid.*, 15, pt. 145.
[213] *Ibid.*, 16, pt. 150-151.
[214] J. BERNSTEIN, "Transfer Pricing In Canada", *Bull. for Int. Taxation* 1999, (570) 576.

Germany

Germany has introduced its proper version of the CWI standard in 2008. The provision is included in section 1 of the Foreign Tax Act[215] (§ 1 Abs. 3 AStG).

Legislation

A clear hierarchy of pricing methods is included in § 1 Abs. 3 AStG. The OECD's traditional transaction methods have priority. If they cannot be applied, methods such as the TNMM can be used. Only if that's not possible, a hypothetical arm's length price should be determined. This can be done using the transactional profit split method.

Under the profit split method, the scope of agreement is to be determined according to section 7 of the Decree Law (§ 7 FVerlV)[216]. For the determination of this scope, the notion of the prudent and conscientious business manager ("ordentlicher und gewissenhafter Geschäftsleiter")[217] is of importance. The scope is defined by the maximum price that a diligent and conscientious licensee would pay, and the minimum price a diligent and conscientious licensor would accept[218]. These prices are based on a DCF analysis. The upper bound is guided by the reasonable expected profit potential for the transferee, where the lower boundary is set by the reasonably expected profit forgone by the transferor[219].

The German version of the CWI standard is limited to two sentences. If the profits derived from an intangible deviates significantly from the projections within ten years following the transfer, there is a rebuttable presumption that independent parties would agree on a price adjustment. If the intercompany transfer agreement does not include such price adjustment clause, the tax authorities can make a one-time adjustment the year after such deviation occurred.

[215] Gesetz über die Besteuerung bei Auslandsbeziehungen (Außensteuergesetz), *BGBl.* 12 September 1972.
[216] Verordnung vom 12 August 2008 zur Anwendung des Fremdvergleichsgrundsatzes nach § 1 Abs. 1 des Außensteuergesetzes in Fällen grenzüberschreitender Funktionsverlagerungen (Funktionsverlagerungsverordnung - FVerlV), *BGBl.* 18 August 2008, 1680.
[217] § 1 Abs. 1 S. 3 AStG.
[218] W. KESSLER and R. EICKE, "Out of Germany: The New Function Shifting Regime", *TNI* 2007, (53) 55.
[219] S. SCHNORBERGER, "Arm's Length Principle, Exit Tax and Commensurate with Income Standard: Some Practical Thoughts on the New German Transfer Pricing Rules 2008", *Intertax* 2008, (25) 26.

The German CWI standard is specific to intangibles[220], and limited to only those cases where no comparables were available. As a result of the pricing method hierarchy, it will be mostly applicable to HTVI.

Reconciling with HTVI

Germany has used concise wording to introduce the CWI standard into its Foreign Tax Act. In doing so, it omits safe harbour rules. Unlike the OECD guidance, unforeseen events cannot be called upon to avoid the adjustment by the tax authorities.

The tax authorities can make adjustments if the realised profits differ significantly from the projections underlying the transfer pricing. According to section 10 of the Decree Law (§ 10 FVerlV), significant deviations exist if the transfer price determined on the ex post outcome lies outside the ex ante scope for agreement[221]. Contrary to the OECD guidance, German law does not take into account the probabilities and risks that exist a priori. The actual profits attributable to an intangible are the materialisation of one of the potential outcomes, possibly one of the better. Independent enterprises would not price their bid for a license solely based on such, at the outset optimistic, scenarios. They would also not agree on contingent payments or price adjustment clauses, while being exposed to the downside risk. The German lawmaker claims the upside potential of HTVI transfers, without accepting exposure to the downside risk.

Scope of agreement

HTVI are subject to uncertainties at the time of the transfer. A prudent and diligent licensee would include the risks in the maximum price he is willing to pay. Before proof of concept and regulatory approval of a pharmaceutical drug, no prudent and diligent licensee would pay the value that can be ascribed to that drug after its commercial launch. At the time of CoLucid's IPO, lasmiditan was valued at a fraction of the price eventually paid by Lilly in the acquisition less than two years later[222]. That acquisition price would consequently not have been in the scope of agreement.

Consider a scenario where, at any time before the IPO, CoLucid would have transferred the lasmiditan IP in an intercompany transaction under the German Foreign Tax Act. The scope

[220] *Ibid.*, 27.

[221] See also A. OESTREICHER, "Germany" in INTERNATIONAL FISCAL ASSOCIATION (ed.), *IFA Cahier Volume 102b The future of transfer pricing*, The Hague, Sdu, 2017, (387) 398.

[222] *Supra*, 13.

for agreement would for example have been between $50 and $100 million. The price that would most likely have been agreed between independent parties should be utilised. If this price cannot be determined, the mean of the scope for agreement should be applied. During a re-evaluation after the acquisition by Lilly, the scope for agreement would be adjusted to e.g. $50 million to $1 billion. If the most likely external price cannot be verified, the price would be adjusted to the mean of the new range.

Under the Foreign Tax Act, taxpayers can rebut the presumption that independent undertakings would have agreed to a price adjustment clause[223]. The OECD guidance implies that the tax administration should impose price adjustments only if this would be agreed between independent parties. The burden of proof is reversed. The legal presumption seems unjustified in light of the absence of similar arrangements in third-party dealings[224].

The tax administration has the authority to make a one-time lump-sum adjustment, in the year following the deviation from the projections[225]. This requires the tax authorities to have a good idea of how the profits attributable to the intangible will evolve in future years. At the time of the first deviation, information about the to-be-expected benefits can still be incomplete. The amendment by the German tax authorities can still be far of the eventually realised profits. It could even be manipulated by malevolent enterprises. The information asymmetry is only partially addressed under the German legislation.

Android forecasts

Research and advisory company Gartner, Inc. published forecasts for the evolution of the smartphone market in 2010 and 2011. At that time, the OS Android was relatively new to the market and the smartphone market in general was developing rapidly. The definition of HTVI would have been applicable to Android.

Gartner published its forecast for 2010 in the second half of that same year, and still by the end of the year the number of actually sold Android phones exceeded the forecast by 42%. In early 2011, Gartner published a new forecast. The sales amount of Android smartphones

[223] This is also not in line with CJEU case law, as it can put an undue administrative burden on the taxpayer. Another infringement of EU law could be that the legislation applies only to cross-border transfers, in absence of a similar regulation for domestic transactions. See B. CORTEZ & T. VOGEL, "The (In)Consistency of the German Foreign Transaction Tax Act with European Law", *Intertax* 2011, (404) 410; A. EIGELSHOVEN and K. STEMBER, "New Transfer Pricing Rules", *Int. Transfer Pricing J.* 2008, (63) 67.
[224] *Supra*, 21.
[225] A. OESTREICHER, "Valuation Issues in Transfer Pricing of Intangibles: Comments on the Scoping of an OECD Project", *Intertax* 2011, (126) 128.

surpassed the projection by 23% that same year. The 2010 and 2011 forecasts for four years out underestimated the actual sales by 287% and 115% respectively[226].

The forecasts had underestimated both the size of the total market, and the market share of Android phones. Incumbents in the market using their proprietary operating systems, namely Nokia and Blackberry, were expected to be more resilient then in retrospect proved to be the case. In the 2011 version, Windows Phone was expected to capture a large share of Nokia's fading Symbian operating system.

Gartner cannot be seen as being overly cautious. As part of the legal case Oracle America v. Google, an internal document dated July 2010 was made public. It shows that Google estimated number of Android phones sold and the corresponding market share to be lower than Gartner in its 2010 projections, for each of the years involved[227].

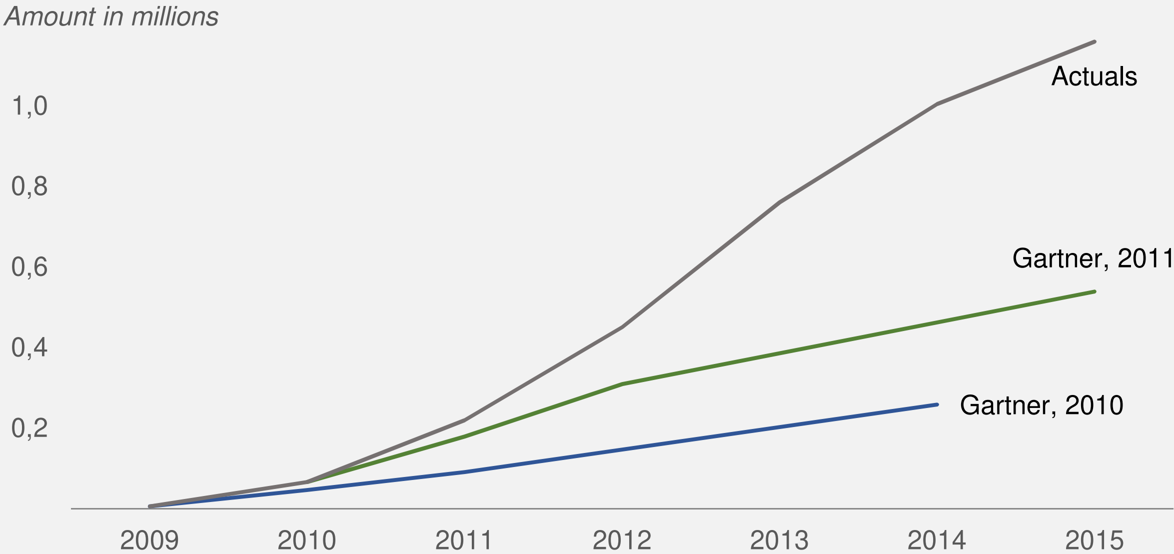

Figure 4: Number of Android phones sold

[226] Data from Gartner, Inc. 2010 forecast and 2009 actuals on www.gartner.com/newsroom/id/1434613; 2011 forecast and 2010 actuals on www.gartner.com/newsroom/id/1622614; 2011 actuals from www.gartner.com/newsroom/id/2017015, www.gartner.com/newsroom/id/1764714, www.gartner.com/newsroom/id/1848514 and www.gartner.com/newsroom/id/2335616; 2012 actuals from www.gartner.com/newsroom/id/2665715; 2013 and 2014 actuals from www.gartner.com/newsroom/id/2996817; 2015 actuals from www.gartner.com/newsroom/id/3061917, www.gartner.com/newsroom/id/3115517, www.gartner.com/newsroom/id/3169417 and www.gartner.com/newsroom/id/3215217 (consultation 21 January 2018).

[227] Trial Exhibit 1061, p. 21, www.theverge.com/2012/4/25/2974909/google-wanted-to-sell-10m-android-tablets-a-year-in-2011-have-33-percent-marketshare (consultation 21 January 2018).

Adjustments to the transfer price can be made until ten years after the initial transfer. This has been criticised to be excessively long[228]. While the OECD guidance only allows for a five year term, the term only starts after the first third-party commercial results have been realised. In reality the term under the OECD proposal may be longer in some cases than under the German rules.

[228] P. CAUWENBERGH and M. O. LUCAS MAS, "The New German Transfer Pricing Rules on Cross-Border Relocation of Functions: A Preliminary Analysis", *European Taxation* 2008, (514) 526.

CONCLUSION

The OECD introduces an approach to deal with the information asymmetry surrounding HTVI. Tax authorities can use the ex post outcome as presumptive evidence for the appropriateness of the transfer pricing. The approach is intended to be consistent with the ALP. The tax administrations hereby face the challenge not to use the posterior results in hindsight, without taken into account what could have reasonably taken into account a priori. Information indicating a potential outcome different from the one that has been realised will appear less relevant in retrospect than beforehand.

Burden of proof

Without elaborating on the defensibility of the measure, the OECD puts the burden of proof with the taxpayer to counter the presumption embedded in the ex post outcome. Large deviations should be evidenced to be due to either unforeseen developments, or the playing out of probabilities duly taken into account when constructing the transfer arrangements. More consideration should be given to how this is compatible with established legal frameworks. The CJEU tends to put the burden of proof with the tax authorities rather than the taxpayer. The rebuttal of the presumptive evidence is also likely to impose an excessive administrative burden on the taxpayer.

Assigning the status of presumptive evidence to the ex post outcome conflicts to the notion of legal presumption under Belgian law. The notion that the actual results differ significantly from the projections lacks a logical reasoning that this could have been taken into account by the taxpayer. The initial burden to proof that such presumption holds, lies again with the tax administration.

Contingent payments

Tax authorities are entitled to adjust the pricing arrangements of the intercompany transfer of HTVI to include contingent payment provisions or price adjustment clauses. Milestone

payments and tiered royalties are common provisions used by independent parties in the licensing of intangibles, especially for HTVI. It is advisable for taxpayers to include market-conform contingent payment clauses in the agreements governing the intercompany transfer of HTVI. The taxpayer can ensure that the appropriate contingent mechanism are put in place, rather than being solely exposed to one-sided adjustments by the tax authorities.

Price adjustment clauses, exposing contracting parties to renegotiation, are generally avoided by independent parties. Associated enterprises therefore should not include such provisions in their agreements. Tax authorities should not impose such arrangements on taxpayers, including clauses enabling an unconditional termination, especially by the licensor. This would conflict with the ALP.

Advance Pricing Arrangements

The OECD introduces some safe havens. Transactions covered by a bilateral or multilateral APA are not subject to the guidance on HTVI. APAs are subject to scrutiny by the European Commission under the State aid prohibition. Where the OECD is seeking to support tax authorities in their efforts to combat BEPS behaviour, the EC is targeting the Member States that provide unfair advantages to MNEs to bring their business into the country. As a result, within the EU, APAs are not the safe harbour the OECD envisions them to be. In other jurisdictions, like the US, APAs are more difficult to be challenged once implemented.

Relevance of the guidance

Certain countries, for example Germany, have implemented a variation of the guidance on HTVI into their legislation. The effort by the OECD to issue specific guidelines on HTVI can streamline the approach across different jurisdictions. However, the practical implementation of the guidance will likely be cumbersome at best.

The approach conflicts with the general principle of legal certainty. HTVI include many uncertainties, also for the taxpayer. The OECD tailors its guidance to accommodate the information asymmetry for the tax administration. The uncertainties from the taxpayer’s perspective are not explicitly acknowledged. The adjustments resulting from the guidance are unpredictable at the time of transfer of the HTVI.

The limited audit terms, for example in Belgium, will likely be more constraining to the implementation of the guidance than recognised by the OECD. As the commercialisation of

HTVI can potentially start only years after the intercompany transfer, tax authorities should start to interpret technical developments to be able make timely adjustments. The problem information asymmetry is in that case de facto not addressed.

Overall, the guidance may prove to be of little relevance. The guidance is largely based on the CWI standard that has been introduced in the United States in 1986. The difficulty of compatibility with the ALP has rendered the standard largely redundant. The OECD guidance may share the same faith due to compatibility issues with national regulations and the ALP.

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ATTACHMENT I: SUMMARY

The OECD aims to tackle Base Erosion and Profit Shifting (BEPS) behaviour by multinational enterprises (MNEs). By exploiting tax loopholes and differences in legislation, MNEs artificially shift profits to low-tax jurisdictions. Intercompany transfers do not always reflect the real value added by the parties involved, and the transactional arrangements can differ from those that would be agreed between independent parties. Especially for intangibles, due to their often unique nature, MNEs can apply transfer pricing that is not fully market conform.

Specific risks for BEPS behaviour have been identified for hard-to-value intangibles (HTVI). This term covers intangibles for which, at the time of transfer, no reliable comparables exist and projections for future cash flows or income exhibit a high degree of uncertainty. The valuation and pricing of HTVI consequently are hard to establish and difficult to check for reasonability. The eventual income attributable to HTVI can deviate significantly from the projections made to determine the value and the corresponding transfer pricing. A natural information asymmetry exists between the tax administration and the taxpayer in assessing the appropriate transfer pricing. Taxpayers generally have more insight into the value of HTVI and can choose which information to present to the tax administration.

The OECD seeks to address the information asymmetry with the issuance of specific guidance to tax authorities for dealing with the intercompany transfer of HTVI. The guidance is largely based on the commensurate-with-income (CWI) standard embedded in the US Tax Code. Tax authorities are empowered to use the ex post outcome as presumptive evidence in the assessment of the ex ante transfer pricing. This presumption is rebuttable by the taxpayer. He needs to demonstrate that all relevant information that was available at the outset was appropriately taken into account for the determination of the transfer price. The taxpayer has to evidence that large discrepancies between the actual and the anticipated profits are due to either unforeseen developments, or to the occurrence of events that were factored in with the appropriate probability.

The implementation of this guidance encounters challenges when reconciling it with the arm's length principle (ALP), as well as the national and supranational legal systems. International examples highlight complexities to apply the proposed approach.

Under the approach proposed by the OECD, tax authorities can impose contingent pricing provisions that would have been agreed between independent parties. Such imposition can be done independently of the pricing arrangements that have been established in the transfer between the associated enterprises.

The OECD explicitly states that the guidance is consistent with the ALP. The use of posterior information should not lead to the use of hindsight without taking into account which information was available ex ante. The compatibility of the guidance with the ALP may give rise to ongoing discussions, as is evidenced by the US. More than thirty years after the introduction of the CWI standard, debates continue on how to reconcile it with the ALP. The standard has largely become obsolete, due to the difficulties applying it consistently with the ALP. Other countries, like Germany, have implemented regulations that include similar features. Such legislations encounter specific difficulties.

Applying the ex post outcome as presumptive evidence conflicts with legislations and jurisprudence on the burden of proof. The Belgian legislation demands a logical deduction from a certain fact before a presumption can be invoked. Moreover, the use of posterior elements is disallowed by the courts. Case law of the Court of Justice of the European Union (CJEU) prohibits that taxpayers are subjected to an undue administrative burden, which is likely to be incurred when rebutting such presumption.

Due to the nature of HTVI, the start of the commercialisation potentially takes place only years after the intercompany transfer. Tax authorities face the problem of statutes of limitations. The ex post outcome may only materialise years after the audit term has expired. The OECD downplays this fact, not recognising the reality of HTVI.

The eventual benefits attributable to HTVI are uncertain for both taxpayers and tax authorities. The use of the actual profits to evaluate the transfer pricing implies that the taxpayer cannot assess the impact of the regulation at the time of entering into the transaction. This creates legal uncertainty that is not tolerated by the CJEU.

Contingent payment arrangements that can be imposed include running royalties, milestone payments and price adjustment clauses. Agreements between independent parties routinely

include payment provisions such as running royalties and milestone payments to accommodate future developments, especially in the case of HTVI. Price adjustments clauses, including renegotiation and unconditional termination clauses, are avoided by diligent actors. Tax authorities should not impose them on intercompany transfers.

The guidance would not be applicable under certain conditions, besides the rebuttal of the presumption based on the ex post outcome. If the transfer pricing based on the actual profits does not deviate more than 20% from the original transfer pricing, no adjustment is made. The approach is also not applied if five years have elapsed since the start of the commercialisation, and the financial results in those five years differed not more than 20% from the forecast. Lastly, no reassessment is done under the guidance if the transaction is covered by a bilateral or multilateral APA.

The European Commission (EC) has launched several investigations into APAs issued by Member States to determine the existence of possible State aid. Where the OECD seeks to support the tax authorities in their combat against BEPS, the EC is scrutinising the deals made by those tax authorities. As a result, the Commission is hampering the application of the guidance on HTVI. APAs are potentially become a liability rather than an asset for MNEs in the European Union. In the US, APAs provide more certainty as the IRS cannot unilaterally revoke them.

Overall, while the OECD deserves merit to propose a uniform approach amongst its members, the drawbacks of the guidance may be too prevalent to overcome. The specific guidance for HTVI may not be suitable for practical application.

ATTACHMENT II: SAMPLED AGREEMENTS

Licensor	Licensee	Date
EirGen Pharma Limited	Japan Tobacco Inc.	12 October 2017
Endocyte, Inc.	ABX Advanced Biochemical Compounds – Biomedizinische Forschungsreagenzien GmbH	29 September 2017
ActiveSite Pharmaceuticals, Inc.	AntriaBio, Inc.	4 August 2017
Immunomedics, Inc.	Seattle Genetics, Inc.	10 February 2017
EirGen Pharma Limited	Vifor Fresenius Medical Care Renal Pharma Ltd	8 May 2016
Emisphere Technologies, Inc.	Novo Nordisk AS	14 October 2015
Catalent U.K. Swindon Zydis Limited	Biohaven Pharmaceutical Holding Company Ltd.	9 March 2015
Eli Lilly and Company	Colucid Pharmaceuticals, Inc.	10 February 2015
Pfenex Inc.	Hospira Bahamas Biologics Ltd.	9 February 2015
ZP OPCO, Inc.	Eli Lilly and Company	21 November 2014
Antares Pharma, Inc.	Lumara Health Inc.	30 September 2014
AMBRX, INC.	Zhejiang Medical Corporation	10 April 2014
Zosano Pharma, Inc.	Novo Nordisk AS	31 January 2014
Dyadic International (USA), Inc.	BASF SE	6 May 2013
Concert Pharmaceuticals, Inc.	Jazz Pharmaceuticals Ireland Limited	26 February 2013
Xenon Pharmaceuticals Inc.	Ivax International GMBH	7 December 2012
Biosante Pharmaceuticals, Inc.	Teva Pharmaceuticals USA, Inc.	8 November 2012
ImmunoGen, Inc.	Bayer HealthCare AG	10 October 2012
Onconova Therapeutics, Inc.	Baxter Healthcare SA	19 September 2012
Annamed, Inc	Dermin Sp. zo.o.	28 June 2012
Leo Pharma A/S	Virobay Inc.	4 January 2012
BioSpecifics Technologies Corp.	Auxilium Pharmaceuticals, Inc.	31 August 2011
Durect Corporation	Zogenix, Inc.	11 July 2011
Pacira Pharmaceuticals, INC.	Novo Nordisk AS	14 January 2011
Intellikine, Inc.	Infinity Pharmaceuticals, Inc.	7 July 2010
ADA-ES, Inc.	Arch Coal, Inc.	25 June 2010
Isis Pharmaceuticals, INC.	Glaxo Group Limited	30 March 2010
Emisphere Technologies, Inc.	Novo Nordisk AS	21 June 2008
M & P Patent AG	Urigen Pharmaceuticals, Inc.	27 November 2007
Neose Technologies, Inc.	Novo Nordisk A/S	2 November 2007
SciDose, LLC	Eagle Pharmaceutical, Inc.	24 September 2007

Tris Pharma, Inc.	Alpharma Branded Products Division Inc.	28 March 2007
Givaudan Schweiz AG	Redpoint Bio Corporation	27 March 2007
Aveo Pharmaceuticals, Inc.	Schering Corporation	23 March 2007
GW Pharmaceuticals PLC	Otsuka Pharmaceutical Co., Ltd.	14 February 2007
Palomar Medical Technologies, Inc.	The Gillette Company	14 February 2007
Metabasis Therapeutics, Inc.	Schering Corporation	13 December 2006
DURECT Corporation	NYCOMED Danmark ApS	29 November 2006
Debiovision Inc.	Salix Pharmaceuticals, Inc.	5 September 2006
Eurand, Inc.	Avanir Pharmaceuticals, Inc.	7 August 2006
Global Gaming Group, Inc.	Spectre Gaming, Inc.	15 May 2006
Eurand, Inc.	SmithKline Beecham Corporation	21 April 2006
Emisphere Technologies, Inc.,	Genta Incorporated	22 March 2006
BioCryst Pharmaceuticals, Inc.	Mundipharma International Holdings Limited	1 February 2006
Scolr Pharma, Inc.	Wyeth	21 December 2005
GPC Biotech AG	Pharmion GmbH	19 December 2005
Biocryst Pharmaceuticals, Inc.	Hoffmann-La Roche Inc.	29 November 2005
Lipoxen Technologies Limited	Baxter Healthcare Corporation	15 August 2005
UST Inc.	Atricure, Inc.	15 July 2005
Clinical Development Capital LLC	BioDelivery Sciences International, Inc.	14 July 2005
ChemBridge Research Laboratories, Inc.	Trimeris, Inc.	8 June 2005
Dow Pharmaceutical Sciences	Skinmedica, Inc.	15 April 2005
Biogen Idec MA Inc.	ImmunoGen, Inc.	1 October 2004
DepoMed, Inc.	Biovail Laboratories Incorporated	27 April 2004
Exhale Therapeutics, Inc.	Schering Aktiengesellschaft	2 October 2003
Antares Pharma, Inc.	Eli Lilly and Company	12 September 2003
Archemix Corp.	Aptamera, Inc.	6 August 2003
Eli Lilly and Company	Neurogenetics, Inc.	21 April 2003
DURECT Corporation	Pain Therapeutics, Inc.	19 december 2002
Neotherapeutics, Inc.	GPC Biotech AG	30 September 2002
Innexus Corporation	Beglend Corporation SA	7 January 2002
ImmunoGen, Inc.	Boehringer Ingelheim International GmbH	27 November 2001
Seattle Genetics, Inc.	Genentech, Inc.	2 March 2001
Generex Biotechnology Corporation	Eli Lilly and Company	5 September 2000
Alkermes Controlled Therapeutics Inc. II	Amylin Pharmaceuticals, Inc.	15 May 2000
Metabasis Therapeutics, Inc.	Sankyo Co., Ltd.	30 June 1999
Progenics Pharmaceuticals, Inc.	Protein Design Labs, Inc.	30 April 1999
ArQule, Inc.	Abbott Laboratories	16 June 1995