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Centre for Tax Policy and Administration
The Organisation for Economic Co-operation and Development

International Tax Committee
Japan Machinery Center for Trade and Investment

Comments on the Discussion Draft of “Implementation Guidance on Hard-to-Value Intangibles”

Japan Machinery Center for Trade and Investment (“JMC”) is a non-profit organization that was established in 1952 to promote sound development of foreign trade relating to machinery in Japan by multi-national entities (“MNE”), and includes the major machinery manufacturers, trading companies, and engineering companies. To enhance the international competitive strength of the machinery industry in Japan, an international tax committee was established in beginning of 1990 to study and encourage the developments of domestic and foreign international taxation systems.
URL：http://www.jmcti.org/jmchomepage/english/index.htm

Transfer pricing issues of intangibles discussed in BEPS Action 8 have very important implications on the business of the member companies of the JMC, which deal in export and investment of machinery equipment including high-tech machinery. Thus, in addition to fully supporting the comments by KEIDANREN to the OECD, we decided to submit our own comments, which particularly related to the circumstances of the JMC member companies.

<General Comments>

The discussion draft provides some guidance for tax administrations regarding the treatment of hard-to-value intangibles (HTVI) with a view to tackling information asymmetry between the taxpayer and the tax administration. We hope that, based on this guidance, common understanding among tax administrations of different countries is promoted.

The discussion draft discusses the possibility of considering the *ex post* outcome as presumptive evidence on the appropriateness of the *ex ante* pricing arrangements. While the taxation based on the *ex post* outcome only is not permitted, some examples are indicated regarding the estimates based on the *ex post* outcomes in case taxpayers cannot provide explanation on the attainability and foreseeability at the time of the initial valuation. From the viewpoint of taxpayers, it is important to have a clear understanding on the proof of attainability and foreseeability. However, as no clear guidance on the evidence for that proof is indicated, taxpayers can be in trouble in the course of actual business. We believe that further guidance has to be indicated clearly. That point is also important for avoiding too broad interpretation by the tax administration.

It is likely that different tax administrations have different views on the *ex post* adjustment, and taxpayers are concerned that it might cause the double taxation. The approach of the discussion draft should be implemented after the effective mutual agreement procedure is established and the international agreement on the dispute resolution mechanism is attained, as mentioned in paragraph 31-32.

The discussion draft provides some examples, making reference to the condition that the approach to HTVI ("commensurate with income standard" in the subsequent part of our comment) is not applied. Thus, it can be useful for understanding the operation mechanism of "commensurate with income standard".

We want to have clearer explanation on the following point:
As indicated in paragraph 6.193 of the Guidelines, "commensurate with income standard" is not applied when the taxpayer provides:

1. Details of the ***ex ante*** projections used at the time of the transfer to determine the pricing arrangements, including how risks were accounted for in calculations to determine the price (e.g. probability-weighted), and the appropriateness of its consideration of reasonably foreseeable events and other risks, and the probability of occurrence; and,
2. Reliable evidence that any significant difference between the financial projections and actual outcomes is due to: a) unforeseeable developments or events occurring after the determination of the price that could not have been anticipated by the associated enterprises at the time of the transaction; or b) the playing out of probability of occurrence of foreseeable outcomes, and that these probabilities were not significantly overestimated

or underestimated at the time of the transaction.

In the examples in the discussion draft, the operation mechanism of "commensurate with income standard" is explained on the presumption that taxpayers cannot explain the unforeseeability at the time of the transaction. In practice, even if the taxpayer explains the unforeseeability, the tax administration might figure that the explanation of the taxpayer is not reliable. We hope that the guidance is provided in the examples on the reason of the judgement by the tax administration concerning the explanation by the taxpayer and on the concrete conditions required for the sufficient proof by the taxpayer which can be judged as being reliable by the tax administration.

<Introduction>

1. We appreciate the efforts made by the party concerned in that the implementation guidance is arranged within the framework of the arm's length principle. At the same time, we would like to reassure that the arm's length principle is fully esteemed. We consider that it should be clearly indicated that the application of "commensurate with income standard" is limited to the cases where the pricing of intangibles between associated enterprises deviates from the arm's length principle.
2. Paragraph 6.192 of Guidelines refers to "the determination of the arm's length arrangements, including any contingent pricing arrangements that would have been made between independent enterprises at the time of the transaction". However, contingent pricing arrangements are not usually used, or only used very rarely in transferring intangibles between independent enterprises. Because ex post adjustment of prices of intangibles is seldom implemented between independent enterprises, the scope of the application of "commensurate with income standard" on associated enterprises should be limited strictly.
3. In the examples in the discussion draft, a pharmaceutical compound is illustrated. However, use of a pharmaceutical compound does not necessarily seem be useful as a guidance for machinery industries where a lot of patents and other intangibles are used for one product.
4. We understand that one product is protected by one or several patents in the case of pharmaceutical compound. In the case of machinery, including electric or transportation machinery, thousands or even ten thousands of patents are used for one product. When only one or several of these numerous patents are transferred, it is virtually impossible to evaluate the profit produced by the transferred patents.
5. Therefore, we think that the application of "commensurate with income standard" should be limited to the following cases of large-scale or important transfers of intangibles: (i)

So many patents for one product are transferred to overseas associated enterprises that the transfer of these patents has an important influence on the sales of that product. (ii) The scope of regions where the transferred patents are protected is so wide that the amount of sales of the product using the patents in these regions is large and important. (For example, while the parent company keeps the right to sell the product within the resident country of the company, the right to use the patents in any other counties or regions is transferred to an overseas associated enterprise.)

6. In other words, “commensurate with income standard” should not be applied in the following cases unless they involve large scale and important transactions indicated in 5. above. Instead, the pricing based the cost of research and development for the invention (cost plus method) should be admitted. (i) The case in which the inventions by overseas subsidiaries on consignment development are transferred to the parent company based on the policy to concentrate intellectual property to the parent company. (ii) The case in which the parent company buys the patent developed independently by an overseas subsidiary.

<Example 1>

1. In Example 1, the reason why the tax administration corrects the price from 700 to 1,000 is the sales are realized earlier than anticipated, but it seems that this fact alone is not sufficient to conclude that the price should be corrected upwards retroactively. It might be the case that the efforts by the patent buyer made the earlier sales possible. More explanation is needed on the conditions of this example.
2. If the Phase III trial was completed earlier because of the efforts by the company that purchased the patent, it is more reasonable from an economic point of view to allocate the increased profits to that purchasing company.
3. Paragraph 19 (and also 24) refers to the explanation by the taxpayer on the properly taking account of the possibility at its original valuation and on the unforeseeability of the development. We would like you to provide us with clearer guidance about the expected level of proof.

<Example 2>

1. In Example 2, the timing of correcting the price does not retroact to the time of transaction (Year 0) as in Example 1, but only to Year 3. However, there is no essential difference between them because the price correction retroact to previous years from the audit period in both examples.
2. “The successful completion of development phases or regulatory approvals in a particular

market" (in paragraph 28) might due to the efforts made by company that purchased the patent. Therefore, it is not reasonable to conclude that the price should be corrected upwards retroactively based on that fact only. More explanation on the factual background is needed.

3. Paragraph 28 reads that "this paragraph in not intended, and does not, imply that modification of the payment form can only occur when there is a common practice in the relevant business sector regarding the form of payment for the transfer of a particular type of intangible." However, we cannot agree to the notion that the concept of "additional contingent payment" is applied regardless of the common business practice.
4. Example 2 seems to imply that the tax administration can construct a contract that include contingent payment clause, which did not exist in the original contract, and can tax at the time of contingent payment, regardless of the actual price setting practice in the relevant business sector. To dare to take that approach, although the same result can be achieved by taxing at the time of the initial transaction, seems to imply to virtually abolish the statute of limitation and to come close to introduce the income recalculation after the all actual data are available. From the viewpoint of taxpayers, the statute of limitation is useful in mitigating the tax risk and constructing a contract by the tax administration goes too far.

<Example 3>

1. In deciding the royalty payment rate during the contract period, it might be common in the pharmaceutical patent to determine the rate by dividing the value of the intangible (700) by the present value of sales over the contact period (3,500); in this example, 700/3,500=20%. However, this method is not generally used in the machinery industry, where so many patents are used for one product.
2. In the machinery industry, it is next to impossible and unrealistic to evaluate each patent one by one. Thus, in many cases, low royalty rate as a ratio of sales of patented products or small amount of royalty per one unit of patented products are set in the price negotiation between the licenser and the licensee, taking the "industry standard" into account. In these cases, it is virtually impossible to reevaluate each patent even *ex post*. Thus, it seems to be difficult for the tax administration to implement transfer pricing taxation by correcting the royalty rate *ex post*.
3. However, to the case of large-scale or important transactions of intangibles as explained in <Introduction>5, the approach presented in Example 3 might be applicable. Therefore, in examining the applicability of "commensurate with income standard", the scope should be limited to these cases as indicated in <Introduction> 5.

4. Example 3 illustrates the situation where the received royalty is corrected upwards in case the income or cash flow increase more than expected and that the taxpayer cannot demonstrate that it was unforeseeable. We wonder if there can be a case in which royalty payment is corrected downward (denial of inclusion in expenses of the royalty payment) when the income or cash flow is lower than expected in the application of "commensurate with income standard".

<HTVI and the Mutual Agreement Procedure>

1. Whether "Commensurate with income standard", which is to be applied to "hard-to-value" intangibles, works in practice or not critically depends on the effective function of the adjustment of double taxation through the mutual agreement procedure. Therefore, the importance of the effective function of the mutual agreement procedure cannot be emphasized too much.
2. From the view point of taxpayers, we request that the tax administration, which is to start to apply transfer pricing taxation based on "commensurate with income standard", goes into the mutual agreement procedure with the other tax administration and that the upward correction by the tax administration is implemented simultaneously with the downward correction by the other tax administration, after the agreement is reached between these tax administrations to avoid the double taxation.
3. The discussion draft does not examine the relationship between "commensurate with income standard" and mutual agreement procedure in details, and indicates that this issue is to be discussed in the framework of BEPS Action 14. We hope that the tax administration which applies transfer pricing taxation based on "commensurate with income standard" is strongly requested to resolve the double taxation issue, without delay, through the effective mutual agreement procedure.
4. In case the implementation guidance on "commensurate with income standard" of hard-to-value intangibles are published as the final report, the double taxation adjustment through the mutual agreement procedure should be included in the final report as a set of the implementation guidance.
5. On the adjustment of double taxation through the mutual agreement procedure should become effective as the binding implementation guidance, even if it is not a part of the Guidelines itself. Otherwise, we are concerned that the risk of double taxation might further increase than before

JMC

The topic discussed in the discussion draft is very relevant and important for many Japanese exporting companies, and the JMC would like to thank the OECD for providing us with the opportunity to comment on the discussion draft.

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