Transfer Pricing Developments BEPS

Saturday December 5, 2015

Session 11.00 – 13.00

JUBILEE CONFERENCE 1995 - 2015
FOUNDATION FOR INTERNATIONAL TAXATION

Chairman: Rohan Shah, Economic Laws Practice, India

Panel Leader: Caroline Silberztein, Baker & McKenzie, France

Panellists:

- Carol Dunahoo, Baker & McKenzie, USA
- Michael Durst, USA
- Vijay Iyer, Ernst & Young, India
- Sanjiv Malhotra, Baker & McKenzie, Singapore
- Rohan Phatarphekar, KPMG, India
- G.C. Srivastava, India

PART 1 – BEPS TP UPDATE

Why the BEPS project ?

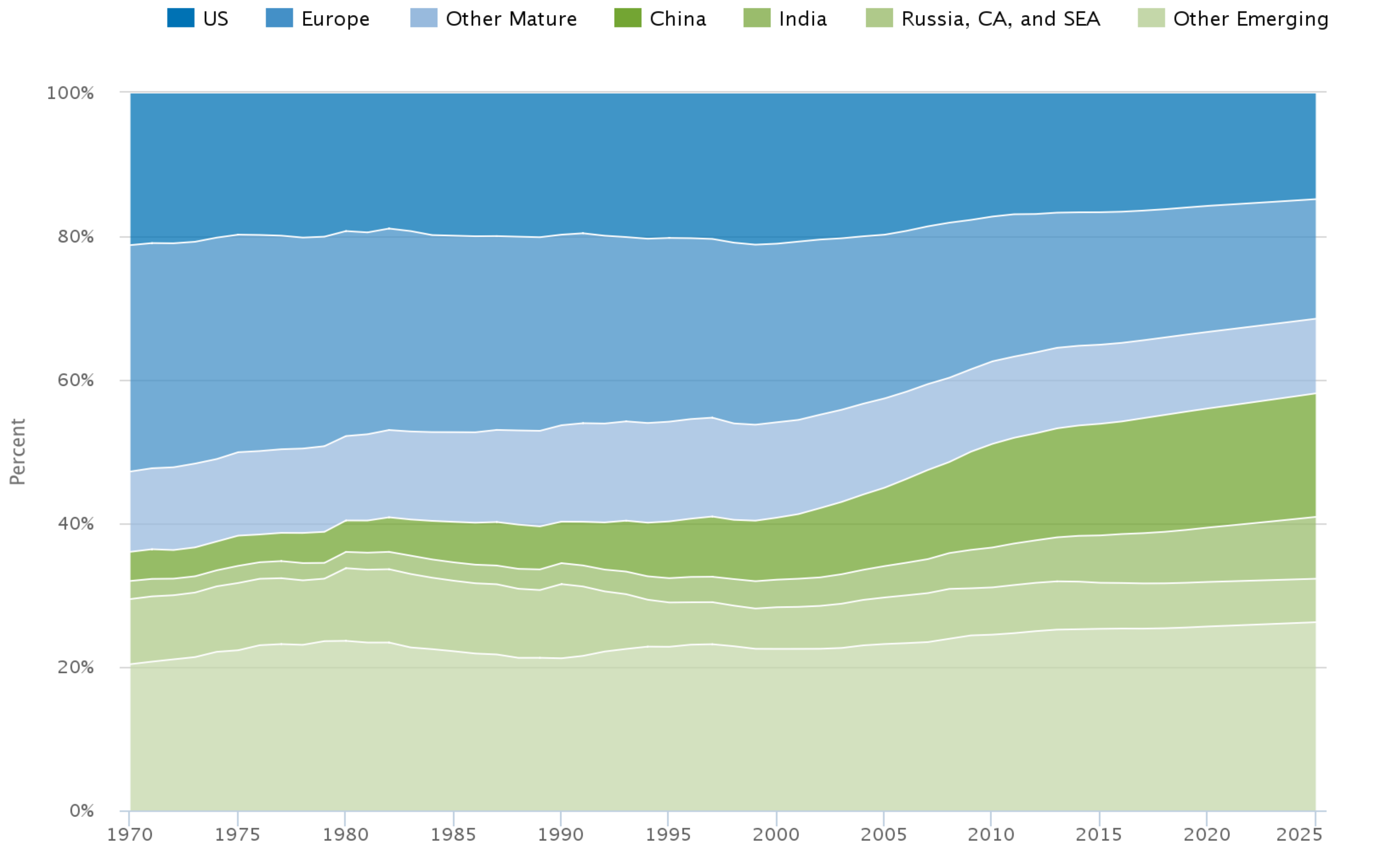
Two major policy concerns

Concentration of residual profits in low tax countries	Views of emerging and developing economies

The BEPS project

A two-year Action plan (covering 15 items) with the G20	A series of 13 Reports adopted in Oct. 2015	Implementation and monitoring work

Regional Distribution of Gross Domestic Product, 1970-2025



Note: Shares are based on GDP in US$ at current purchasing power parities.
Europe includes all 28 members of the European Union as well as Switzerland, Norway, and Iceland. Other advanced economies are Australia, Canada, Israel, Hong Kong, South Korea, New Zealand, Singapore, and Taiwan Province of China. Southeast Europe includes Albania, Bosnia and Herzegovina, Macedonia, Serbia and Montenegro, and Turkey.
Source: The Conference Board Global Economic Outlook 2016 and The Conference Board Total Economy Databaseâ„¢, May 2015

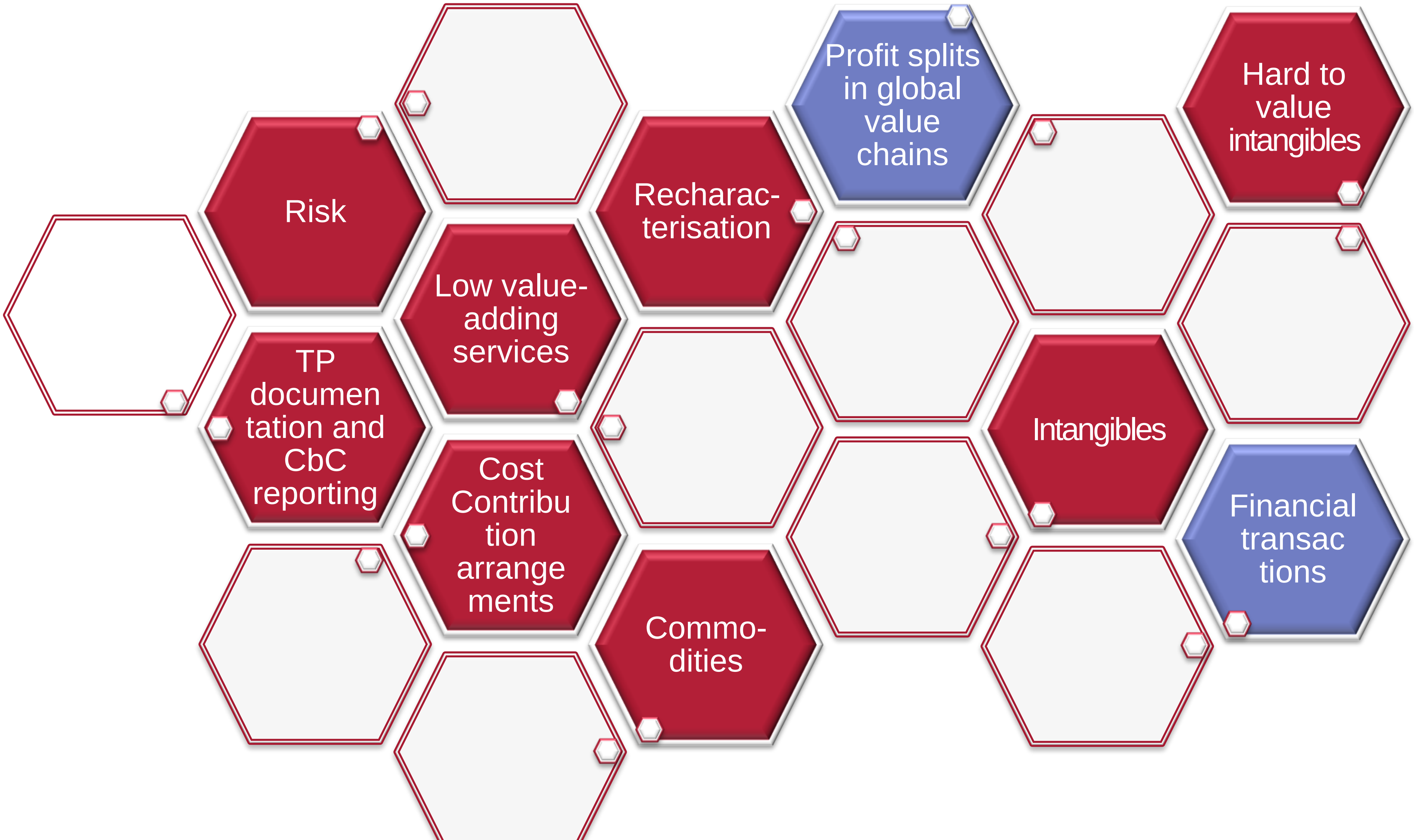
OECD
BETTER POLICIES FOR BETTER LIVES

UNITED NATIONS

European Commission

EUROPEAN COMMISSION

Transfer Pricing BEPS developments: OECD/G20



Final reports dated Oct. 5, 2015

Substantive work to be done in 2016

Transfer Pricing BEPS developments : **United Nations**

- Revision of the UN Transfer Pricing Manual for Developing Economies : to be approved Oct. 2016
  - New chapters on services, intangibles, business restructurings
  - Reflect the outcomes of the BEPS project ; perspectives of emerging and developing economies
  - Consistency with OECD-G20 reports ?

Transfer Pricing BEPS developments : **India**

- What does the BEPS project mean for India ?
  - Risk bearing versus risk management
  - R&D funding versus R&D (=> Circular 6 from June 2013)
  - Brand ownership versus distribution and marketing; marketing intangibles
  - Location savings
  - Other BEPS Action items (e.g. treaty benefits, permanent establishments)
- Involvement in OECD-G20 and in U.N. work
- Progress made on APAs
- Dispute resolution ? Arbitration ?

Transfer Pricing BEPS developments : **China**

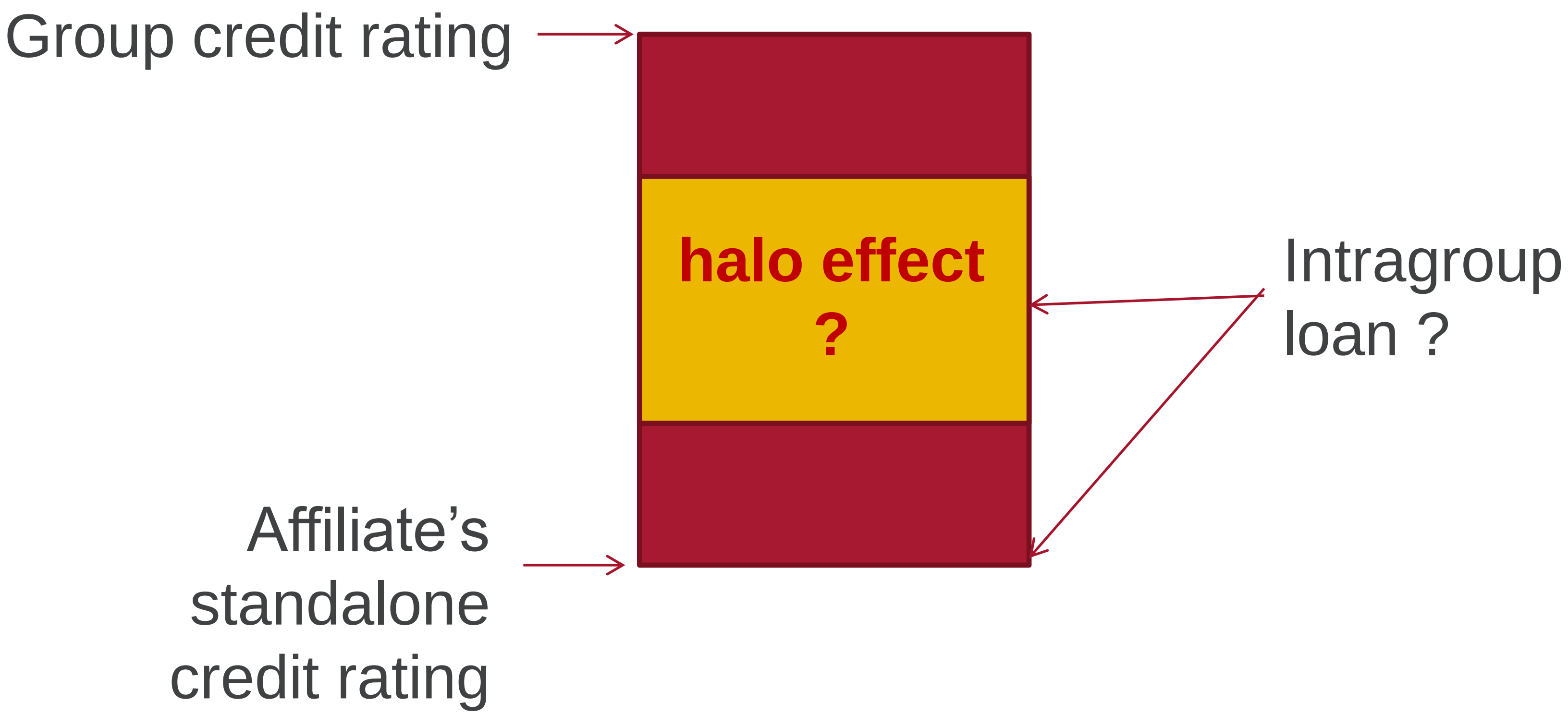
Discussion draft released on 17 Sept. 2015 ; replace current Circular 2. Decree expected before end of 2015 :

- New TPD requirements, which include country-by-country (CbC) reporting;
- Value contribution allocation method as an alternative to other TP methods for allocating MNC profits;
- Mandatory secondary adjustments;
- Corresponding adjustments for purposes of taxes other than enterprise income tax (EIT)
- Location specific advantages (LSAs); and
- New chapter on intangibles to distinguish legal ownership and economic ownership of intangibles.

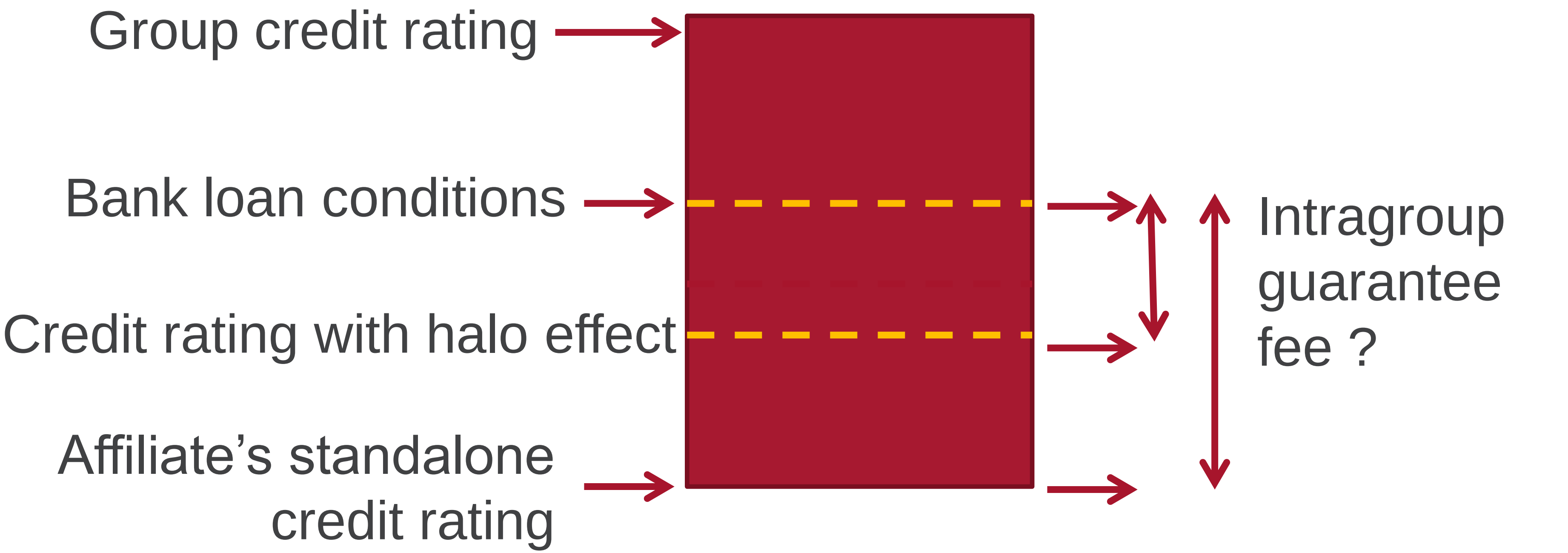
PART 2 – SELECTION OF TECHNICAL ISSUES

1. SYNERGIES

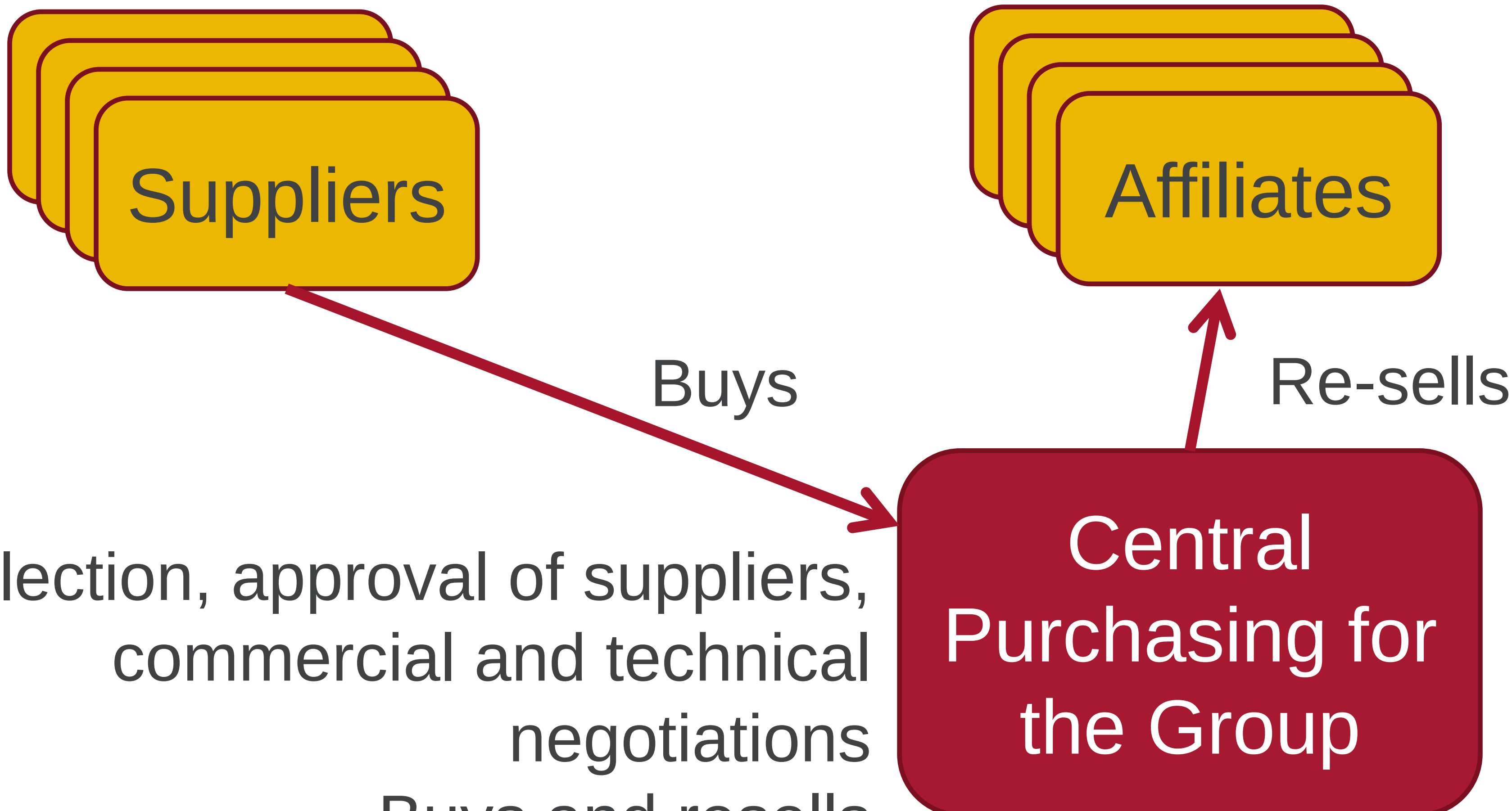
Example : Credit Rating
(OECD-G20 Report Oct. 2015, paras. 1.164-1.166)



Example : Guarantee by parent company on third party bank loan (OECD-G20 Report Oct. 2015, para. 1.167)

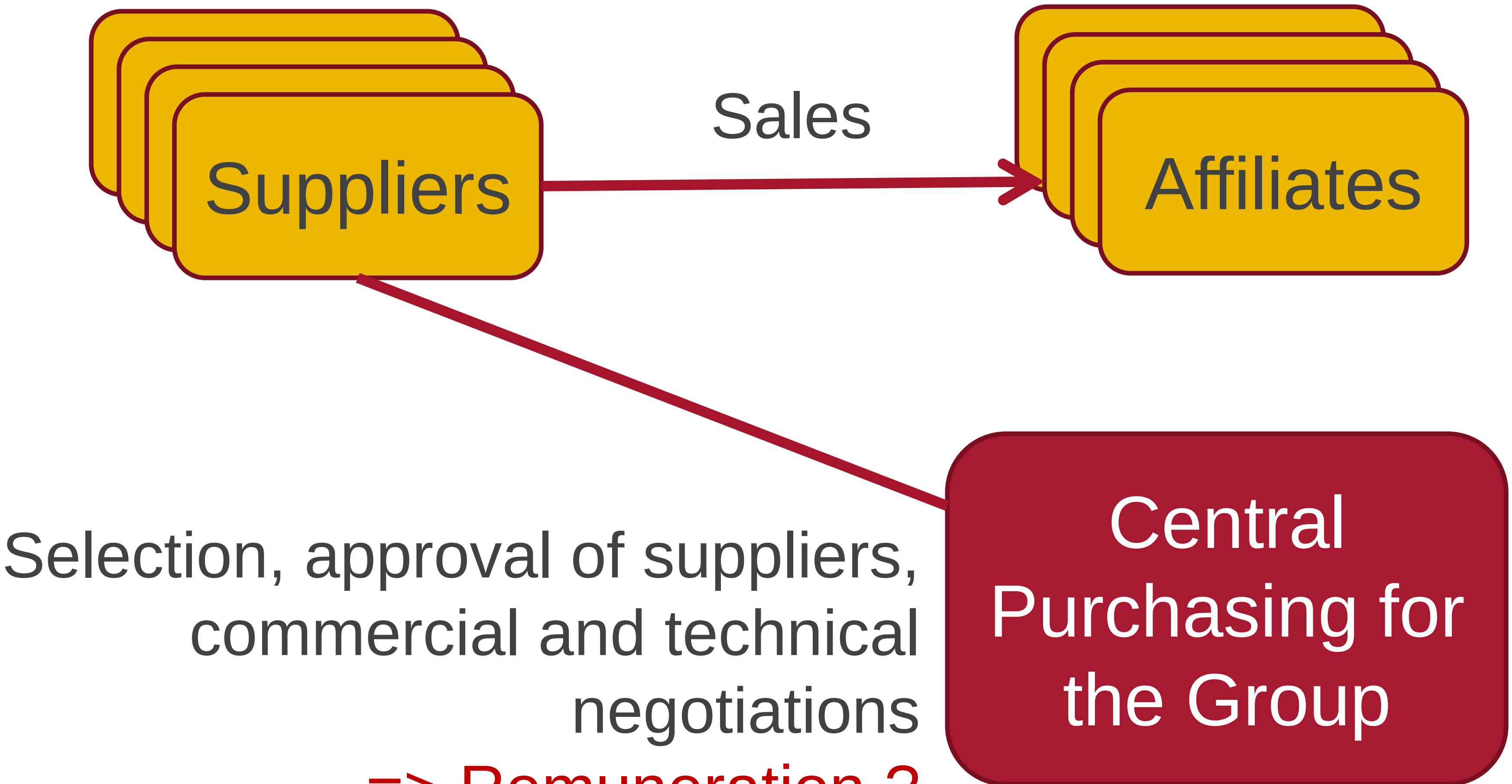


Example : Central purchasing
(OECD-G20 Report Oct. 2015, para. 1.168)



Selection, approval of suppliers,
commercial and technical negotiations
Buys and resells
=> Remuneration ?

Example : Central purchasing
(OECD-G20 Report Oct. 2015, para. 1.169)



2. TOWARDS A BROADER APPLICATION OF PROFIT SPLIT ?

Towards a broader application of Profit Split ?

- **2010** OECD TPG : Profit split method will generally be the most appropriate method where each party to a transaction makes valuable, unique contributions.
- December **2014** : OECD releases a discussion draft on the use of profit splits in the context of global value chains as part of the work on BEPS Action 10
- October **2015** : OECD releases :
  - Revised guidance on risks (importance of control functions)
  - Revised guidance on intangibles (importance of the Development, Enhancement, Maintenance, Protection and Exploitation functions)
  - Scope of work for guidance on the Transactional Profit Split Method

What does the future hold ?

Can a ‘Modified TNMM” Help Ensure Reasonable Income from Activities Performed?

- Basic idea: Use method like TNMM, but instead of basing required margin on comparables, base it instead on group’s consolidated margin (perhaps requiring affiliate to earn 50% of group’s margin)
- Whereas today’s TNMM requires taxpayer to maintain minimum “net operating income,” consider instead basing required return on group’s earnings before tax (EBT) to obtain some control over interest deductions
- Could serve as backup to current OECD transfer pricing methods

3. RISK ALLOCATION

Risk management (OECD/G20 Report)

“Function of assessing and responding to risk associated with commercial activity”.

(i) capability to make decisions to take on or decline a risk-bearing opportunity, together with the actual performance of that decision-making function,

(ii) capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision-making function, and

(iii) capability to mitigate risk, that is the capability to take measures that affect risk outcomes, together with the actual performance of such risk mitigation.

(i) + (ii) = Control over risk

(iii) = Risk mitigation

Example 1 – Product defect risk

- Company A manufactures and sells cars.
- It hires Company B to manufacture braking systems.
- The technology for braking systems belongs to Company A.
- Company A sets strict guidelines for Company B’s manufacturing process. It further sets strict quality audit processes which Company B is required to follow.
- Company B manufactures the braking systems and is responsible for performing the quality audits.
- **Who should be considered to bear the risk in case of product defect ?**

Example 2 – Product defect risk

- Company A manufactures and sells cars.
- It hires Company B to manufacture braking systems.
- The technology for braking systems belongs to Company A.
- Company A communicates to Company B the quantities and production schedule.
- Company B sets its own quality audit processes.
- **Who should be considered to bear the risk in case of product defect ?**

Example 3 – Product defect risk

- Company A manufactures and sells cars.
- It hires Company B to manufacture braking systems.
- The technology for braking systems belongs to Company A.
- Company A sets strict guidelines for Company B’s manufacturing process. It further sets strict quality audit processes which Company B is required to comply with.
- Company B manufactures the braking systems and is subject to quality audits performed by Company A.
- **Who should be considered to bear the risk in case of product defect ?**

4. CONTRACT R&D

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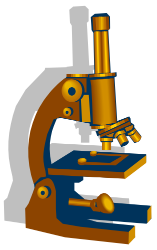
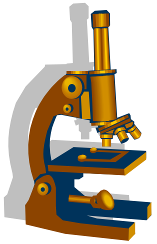
Example 4



- Company X invests $50 m in an innovative R&D programme.
- It hires Company B to perform part of the testing operations.
- Company B will operate within strict guidelines set by Company A.
- Company A pays Company B a fee amounting to Company B's full costs + 10%.
- **Who should be considered to bear the risk in case of R&D failure ?**
- **Who should be considered to be the owner(s) of the intangible in case of success ?**

Example 5



- Company X invests $50 m in an innovative R&D programme.
- The programme is designed by Company B.
- Company B will operate autonomously with limited reporting to Company A.
- Company A pays Company B a fee amounting to Company B's full costs + 10%.
- **Who should be considered to bear the risk in case of R&D failure ?**
- **Who should be considered to be the owner(s) of the intangible in case of success ?**

5. TP DOCUMENTATION & COUNTRY-BY-COUNTRY REPORTING

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What is CbCR designed to tackle?

- Global corporate income tax revenue loss estimated at "at least" $100 to 240 billion annually (but accurate measurement is problematic)
- CbCR designed to help countries focus audit efforts on where there is evidence of potential BEPS

Master file, Local files

- Should we expect significant changes in the way TP documentation reports are prepared and used ?

OECD-G20 CbCR template

- **By jurisdiction**
  - Revenues (related party / unrelated)
  - Profit (loss) before income tax
  - Income tax paid (cash basis) and accrued
  - Stated capital and accumulated earnings
  - Number of employees (FTEs)
  - Tangible assets, other than cash/cash equivalents
- **By constituent entity**
  - Country of organization / incorporation (if different)
  - Main business activity

Questions

- Adoption by non-OECD, non-G20 economies ? Same template ?
- Use of data : risk assessment or formulary apportionment?
  - Note limitations in agreed package.
- Filing process ?
- Confidentiality of data ?
  - Sharing information with subsidiaries ?
  - Public release of information ?
- IT systems required to reliably/efficiently gather data?
- Will the data be audited? By whom / how ?

6. IMPLEMENTATION ISSUES

Implementation

- Immediately!

  “We had to repair the existing transfer pricing system and that is what we have done…. with the new transfer pricing rules, which by the way are immediately implementable as they are the authorizing interpretation of the existing Article 9 of tax treaties.”

  - Pascal Saint-Amans, OECD Press Conference, Oct. 5, 2015

Implementation (cont.)

- The Report on Actions 8-10 is largely silent on implementation
- When asked at July 2015 consultation, the OECD Secretariat said that it will be decided at a national level
- The Executive Summary says the Report “represents an agreement of the countries participating in the OECD/G20 BEPS Project,” but acknowledges that not all countries “formally subscribe” to the OECD TPG (p. 28)
- The Explanatory Statement says “not all BEPS participants have endorsed the underlying standards on tax treaties or transfer pricing” (p. 6).

Implementation (cont.)

- Mode and timing of implementation likely to vary
  - Domestic action, reliance on BEPS reports/amended TPG, other multilateral guidance? OECD members vs. G20, ROW?
  - May the new measures be implemented for past years? Should they be, when the BEPS documents acknowledge that many changes were made and more to follow in 2016-17?
  - Is transfer pricing so different from other treaty issues?
- Risks of uncertainty, hindsight, inconsistent application, controversy

Conclusion

Q & A

Thank you