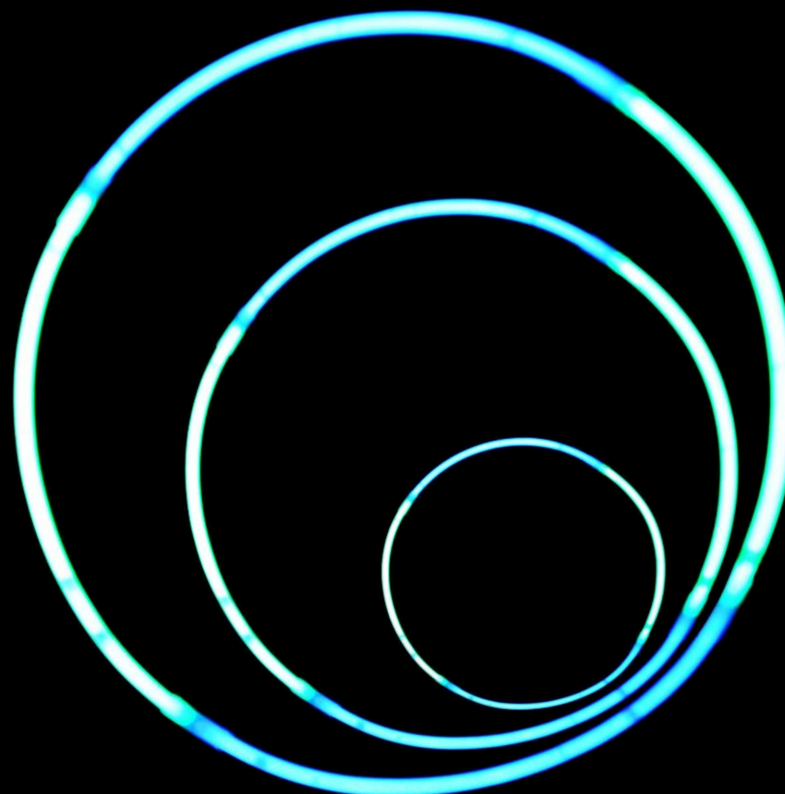
FIT Conference

BEPS Actions 8-10, Transfer Pricing



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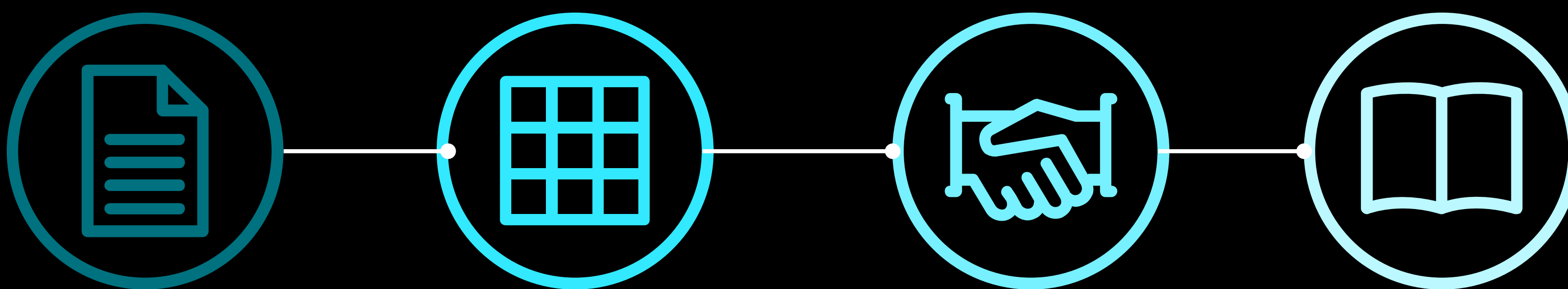
The Global Tax [r]Evolution

This new global tax environment has resulted in the following actions – A Global Tax [r]Evolution



Change in tax authorities' approach to interpretation of tax law and tax treaties

Responsible Tax agenda

Unilateral action

OECD's BEPS project

BEPS is part of the bigger picture

Introduction

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Address the tax challenges of the digital economy</td></tr>
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ACTION

8

Aligning Transfer Pricing Outcomes with Value Creation

"Develop rules to prevent BEPS by moving intangibles among group members. This will involve:

I. adopting a broad and clearly delineated definition of intangibles;
II. ensuring that profits associated with the transfer and use of intangibles are appropriately allocated in accordance with (rather than divorced from) value creation;
III. developing transfer pricing rules in relation to hard-to-value intangibles; and
IV. updating the guidance on cost contribution arrangements."

ACTION

9

Aligning Transfer Pricing Outcomes with Value Creation

"Develop rules to prevent BEPS by transferring risks among, or allocating excessive capital to, group members. This will involve adopting transfer pricing rules to ensure that inappropriate returns will not accrue to an entity solely because it has contractually assumed risks or has provided capital. The rules will require alignment of returns with value creation."

ACTION

10

Aligning Transfer Pricing Outcomes with Value Creation

"Develop rules to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties. This will involve adopting transfer pricing rules or special measures to:

I. clarify the circumstances in which transactions will not be recognised;

II. clarify the application of transfer pricing methods, in particular profit splits, in the context of global value chains; and

III. provide protection against common types of base eroding payments, such as low value-add services."

Revisions to Chapter 1

Delineation of the actual transaction, Risk & Non-recognition

Delineation of the actual transaction

"Every effort" should be made to determine the actual nature of the transaction:

1 Analyse the economically relevant characteristics

2 Apply arm's length pricing to the accurately delineated transaction

The contractual arrangements between the parties is the starting point for the proper understanding (delineation) of a transaction

Contract = Conduct →

Contract ≠ Conduct →

1. Observe conduct
2. Disregard contract
3. 'Non-recognise" or adjust

Allocation of risk

1. Identify economically significant risks with specificity
2. Determine contractual assumption of risk
3. Perform functional analysis with specific attention to risk
4. Interpret steps 1-3
5. Allocate risk (if needed)
6. Price transaction

6-step approach to analysing risk in relation to controlled transactions

Facilitates comparison of the contractual terms related to risks

- Risk management people functions
- Financial capacity to bear risk

Non-recognition

What has changed

2010 Guidance (TPG)	Revised Guidance (BEPS Final Reports)
• Substance of a transaction differs from its form	• Observes conduct and economically relevant characteristics over contracts
• Would the transactions have been seen between independent parties	• Apply ALP to the accurately delineated transaction • Control on risk and financial capacity are important considerations
• Suggests that tax administration may disregard the parties' characterization of the transaction, and re-characterize with substance	• MNE group be worse off overall on a pretax basis? • No mention of re-characterization

- Important to examine whether transaction possesses **commercial rationality**, and not whether transaction can be observed between independent parties
- No mention of substance vs. form – identification of the delineated transaction important i.e., **emphasis on conduct, not contracts**
- Guidance to tax administrations: **non-recognition only in exceptional circumstances**

Non-recognition (continued)

Example

S1 is a manufacturer holding substantial inventory and investment in plant and machinery. It owns commercial property situated in an area prone to frequent flooding in recent years. Third-party insurers experience uncertainty over the exposure to large claims. Consequently, there is no market for insurance of properties in the area

S2, an associated enterprise, provides insurance to S1, and an annual premium representing 80% of the value of the inventory, property and contents is paid by S1

Issue

Is this a commercially rational transaction or should it result in non-recognition?

Analysis and conclusion

S1 has entered into a commercially irrational transaction since there is no market for insurance given the likelihood of significant claims

Therefore, the transaction lacks the fundamental economic attributes of arrangements between unrelated parties and should not be recognized

- S1 is treated as not purchasing insurance and its profits are not reduced by the payment to S2
- S2 is treated as not issuing insurance and therefore not being liable for any claim

Non-recognition (continued)

Issues and concerns

- May increase uncertainty, controversy, and potentially double taxation (experience shows stricter standards lead to more aggressive positions by tax authorities)
- May lead to the possible imposition of penalties because tax authorities could take many paths to non-recognition, all of which would need to be considered in documentation
- No guidance on non-recognition of management fee deductions which is a practical concern for many MNEs
- Considerations with new example
  - S1 may be better off demonstrating the negotiation to arrive at ALP and need for insurance (benefit test?)
  - View transaction in totality (e.g., does S2 gain anything out of the transaction itself?)
  - Discussion on “options realistically” available and “financial capacity”
  - Guidance on support for such transactions absent

Location savings and other local market features

Location savings

- Recognition of geographic market features as affecting comparability and ALP
  - Cost savings attributable to operating in a particular market termed as location savings
  - Consideration of local market advantages or disadvantages referred to as local market features

Location savings: Four step process outlined

1	2	3	4
Whether location savings exist	Amount of any location savings	The extent to which location savings are retained or passed on to customers or suppliers by an MNE group member	If not passed on, the manner of retained net location savings allocation

- If reliable local market comparables available, location savings related comparability adjustments not required
- If not available, functional analysis, facts and circumstances should be the basis of an analysis

Local market features

Local Market Features (LMF)

- Reiterates reliable adjustments to improve comparability for

Geographic characteristics	Consumer preference
Purchasing power	Degree of competition
Infrastructure	Proximity to profitable markets
Skill of workers	Market lifecycle

- If CUP available, comparability adjustments not required
- Four step process (similar to location savings) suggested to evaluate LMF
- Highlights clarity between LMF and intangibles (rights or assets)

Implications

- Does not address specific issues in India or China
  - Lack of reliable comparables in China
  - Cost base comparison in India when activities are shifted from a high cost jurisdiction
  - Application of comparability in an MNE value chain
- Clarity on quantification and allocation absent

MNE group synergies

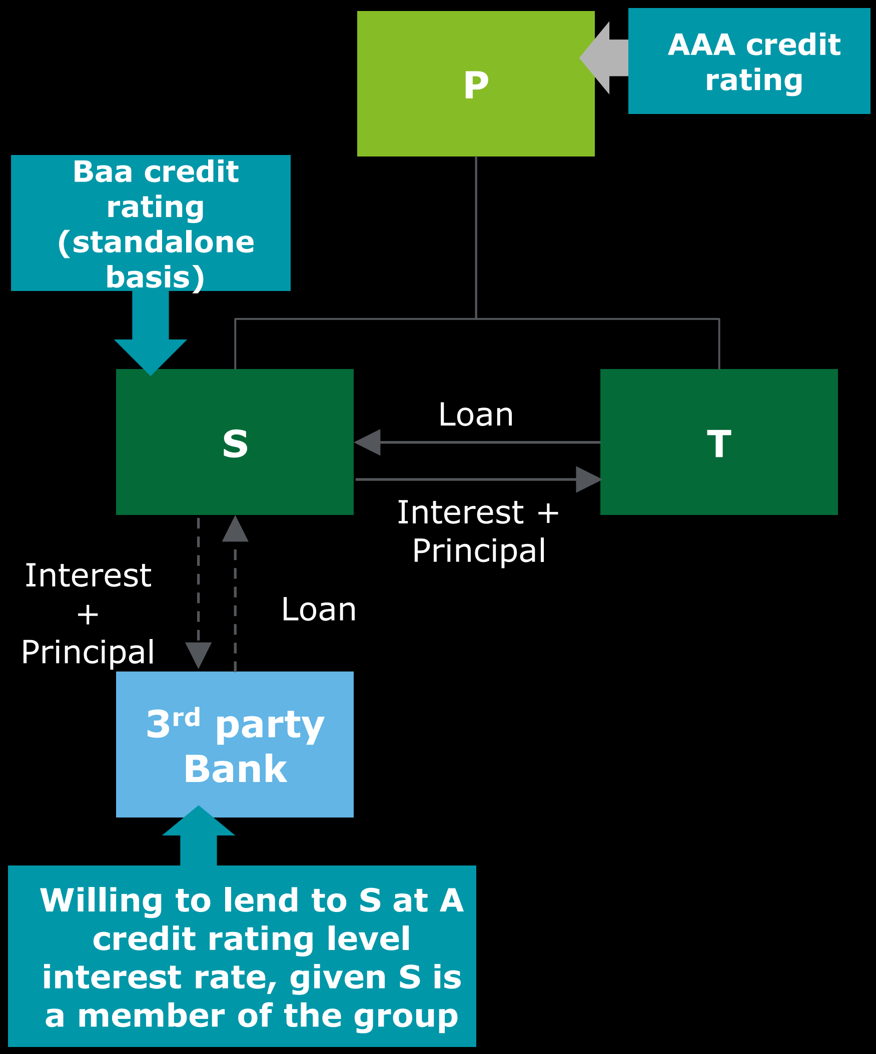
MNE group synergies

Key concepts
Group synergy
Benefit / burden from interaction amongst MNE group members that would generally not be available to similarly situated independent enterprises
Incidental benefit
Benefit arising solely by virtue of group affiliation absent of deliberate concerted action or transactions

Key principles

- Synergistic benefits / burdens purely from MNE group membership without deliberate concerted action by group members need not be separately compensated
- Synergistic benefits / burdens may arise from deliberate concerted action by the group and may give an MNE group material, clearly identifiable structural advantages or disadvantages vis a vis 3rd party market participants and that are involved in comparable transactions
- If important group synergies exist and can be attributed to deliberate concerted group action, the benefits of such synergy should generally be shared by group members in proportion to their contribution to the creation of the synergy (NOTE: this only refers to benefits)

MNE group synergies



Example 1 – incidental benefit

- S borrows the same amount on similar terms from a 3rd party and from T
- The 3rd party rate is a comparable rate for determining the rate between T and S and no adjustment is required for incidental benefit (credit enhancement between Baa and A ratings)

Example 2 – deliberate concerted action

- P guarantees S's loan from a 3rd party allowing S to borrow at AAA credit rating level of interest rate
- The enhancement of S's credit rating from A to AAA is attributable to deliberate concerted action that should be compensated

Intangibles

Substance requirements

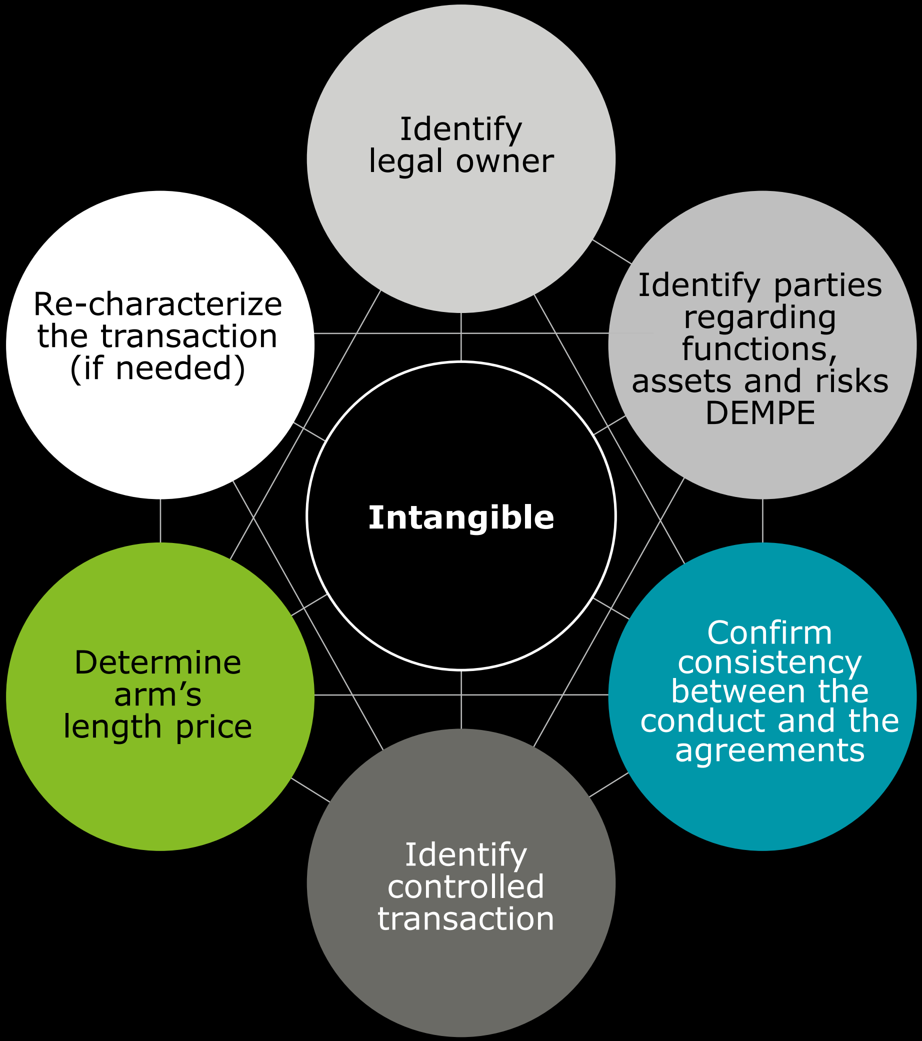
The role of IP in the value chain

Generate	Control	Exploit
Individuals solve problems, make inventions, devise software codes, create images, text, music, design products and develop insights	The business enterprise develops techniques to control the use of this output by using legal rights both statutory and contractual, or custody measures such as encryption, password protection and secrecy	The enterprise creates internal knowledge sharing channels and practices to maximize its ability to exploit the IP in the market The enterprise uses the IP in its external relationships with customers, suppliers, government, employees, and other stakeholders producing economic benefits
Goodwill	**Intellectual Property**	**Intangible asset**

Value →

Substance requirements

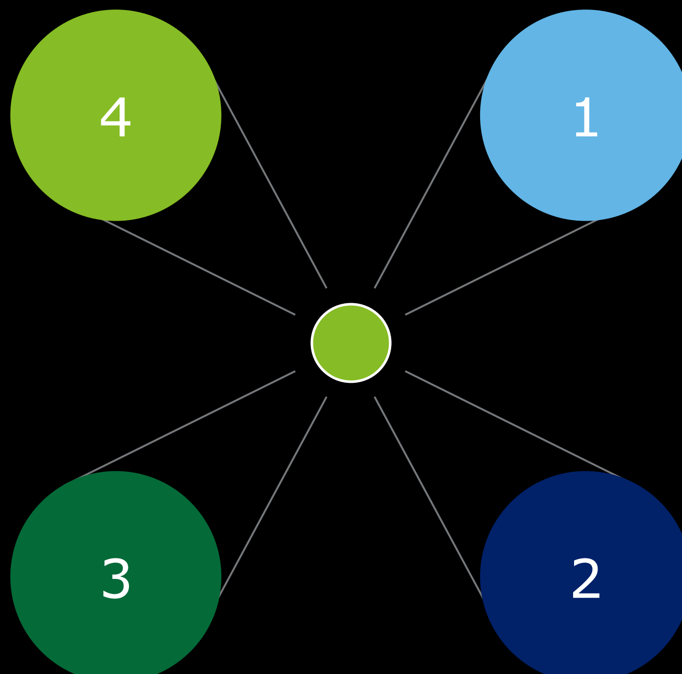
IP Company – Transfer Pricing perspective



Substance requirements

Main questions to be considered in practice

Significant people functions aligned with control over risks?



Legal ownership vs. Economic ownership

Arm's length price: Methodologies based on costs not recommended

Conduct of the parties vs. Contractual terms

Substance requirements

IP Company – DEMPE

DEMPE = Development, Enhancement, Maintenance, Protection, and Exploitation of intangible assets

Important functions	Design and control of research and marketing programs	Management and control of budgets	Control over strategic decisions over intangible development	Important decisions regarding defense and protection	Ongoing quality control
Assets may include	Intangibles used (e.g., know-how, customer relationships)	Physical assets	Funding		
Risks may include	Unsuccessful research and development	Obsolescence through competitor developments	Infringement of own or other rights	Product liability	Exploitation rights

Substance requirements

Cash boxes

A company which

- Does not perform functions to evaluate the financing opportunity
- Does not consider the appropriate risk premium and other issues to determine the appropriate pricing of the financing opportunity
- Does not evaluate the appropriate protection of its financial investment

Factors to consider

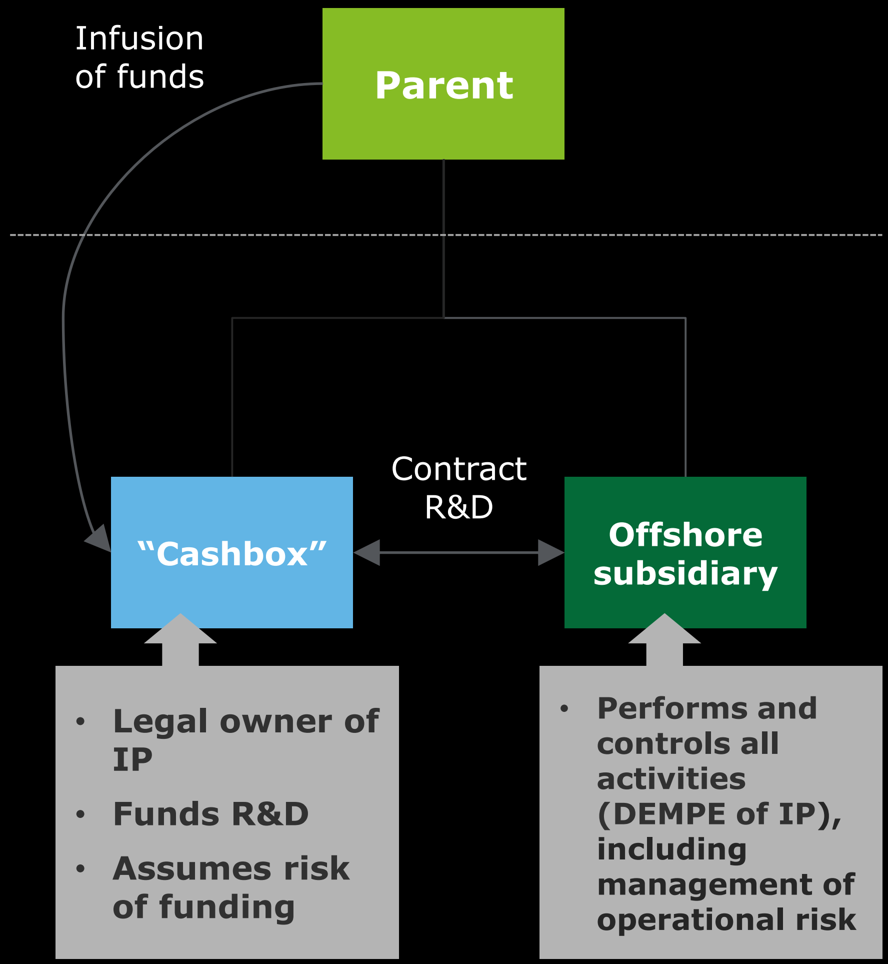
- Functions: The more functions, the less likely it is to be considered as a cash box
- Control over (financial) risk: Key factor in the remuneration and status of a cash box
- Financial capacity: It needs to be in line with the risks incurred

Risks derived from absence of substance

- Applicability of provisions to avoid treaty shopping (BEPS Action 6)
- Applicability of Controlled Foreign Company rules (BEPS Action 3)
- Permanent Establishment risks (BEPS Action 7)
- Re-characterization of remuneration (BEPS Action 4)

Cash box entities

What is the cashbox controversy?

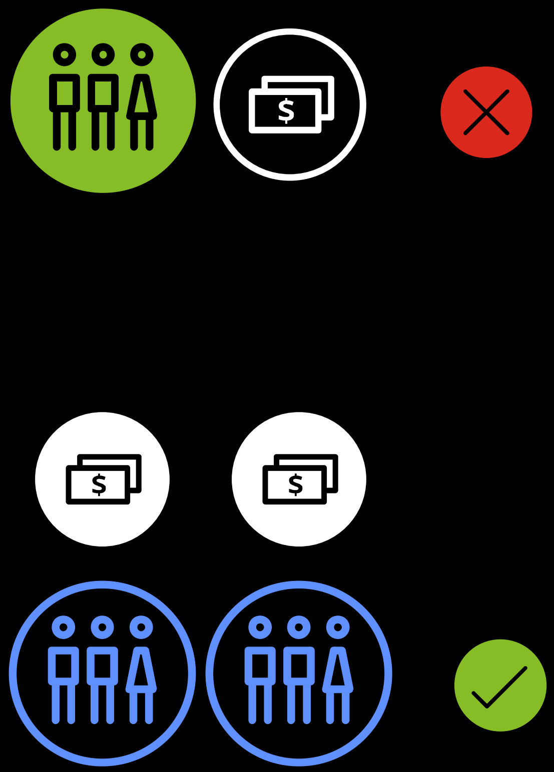


Final BEPS recommendations

- Rejection of special measures and CFC suggestions
- Affirmation that capital-rich entities without relevant economic activities (cash boxes) will not be entitled to any excess profits
- Three scenarios possible
  - No management of funding risk: entitlement to no more than risk-free return
  - Management of funding risk: entitlement to risk adjusted return
  - Management of funding risk and operational risk: not a cash box!

Cost Contribution Arrangement

Cost sharing



- Parties initial and ongoing contributions must reflect expected benefits
- All parties must reasonably be expected to benefit from the Cost Contribution Agreement (CCA) activity
- If one party only has de minimus benefits that party may not qualify as a participant
- All parties must be able to exercise management and control of the financial risks associated with a CCA and have the financial capacity to bear the financial risk undertaken
- Parties must have a clearly defined interest in the output of the CCA activity
- Failure to satisfy these requirements could permit the tax authorities to disregard the CCA if they determine it lacks commercial reality

Marketing Intangibles

Key Points

1. BEPS Action Items 8-10 Report categorizes intangibles into (i) marketing intangibles, and (ii) trade intangibles;

2. "Marketing intangible": Intangible related to marketing activities, which assists commercial exploitation/ promotion of a product/ service;

3. "Trade intangible": Intangible other than a marketing intangible;

4. "Ownership" of an intangible includes 'legal' and 'economic' ownership.

Key Judicial Pronouncements

L G Electronics ITAT SB 23 January 2013	**Sony Ericsson Mobile Comm.** Delhi HC 16 March 2015	**Maruti Suzuki** Delhi HC 11 December 2015	**Bausch & Lomb** Delhi HC 23 December 2015	**Honda Siel** Delhi HC 23 December 2015	**Mondelez India Foods** ITAT 18 May 2016
➢ Applied bright line test (BLT).	➢ Rejected bright line test; ➢ Stand-alone evaluation of AMP expenses caused unusual/ incongruous results; ➢ Distinguished 'pure distribution' and 'marketing' functions; ➢ Combined ALP determination of interconnected marketing and distribution functions, if possible; ➢ Rejected 'routine' and 'non-routine' AMP expense categorization; ➢ Recognized economic ownership of brands.	➢ Rejected approach in LG Electronics w.r.t. international transaction; ➢ Burden to prove international transaction rested on tax authorities; ➢ Examined pre-requisites of 'transaction'; ➢ Existence of international transaction must not be presumed.	➢ Sony Ericsson distinguished; ➢ Opined on the basis of *Maruti Suzuki*: AMP expenses did not meet 'international transaction' prerequisites in absence of an agreement, arrangement, understanding etc. with the AE; ➢ Incidental benefit to AE did not imply that AMP expense was for promoting the AE's brand; ➢ Rejected taxation of 'imagined transaction'.	➢ Existence of trademark license agreement did not imply existence of arrangement/ understanding with AE w.r.t. AMP expenses; ➢ International transaction could not be deduced from 'excessive' AMP expenses; ➢ AMP expenses were incurred for the taxpayer's own benefit.	➢ Local message campaign cannot result in 'international transaction'.

HTVI

Hard-to-value-intangibles

Definition

No sufficiently reliable comparables exist, and

(i) there is a lack of reliable projections of future cash flows or income expected to be derived from the transferred intangible, or

(ii) the assumptions used in valuing the intangible are highly uncertain

Price adjustments unless

- Reliable forecast and unforeseeable events, or foreseeable outcomes were not significantly overestimated or underestimated
- Transfer of intangible is covered by advance pricing agreement
- Differences do not result in changes by more than 20 percent
- Five-year unrelated party revenues and difference was less than or equal to 20 percent

“Hard to value” or “hard to audit”?

Ongoing monitoring and adjustments if required

Low value-adding intra-group services

Low value-adding intra-group services

Highlights

Changes to Chapter VII of the OECD TPG by adding a definition of "low value-adding intra-group services" and provide an elective (optional) "simplified method" for such services

Low value-adding services

- Are supportive in nature
- Are not part of the core business of the MNE
- Do not require the use or creation of unique and valuable intangibles
- Do not involve the assumption or creation of substantial or significant risk
- Changes from draft include clarification provided on software development, ITeS, and management supervision of services
- Cautions that if a company's activities do not qualify for the simplified method, you should not assume that it should generate high returns

What are "low value-adding"	What are not "low value-adding"
Accounting and auditing, accounts receivable / payable, human resources, legal, tax	R&D, manufacturing, sales, marketing, distribution, corporate senior management

Low value-adding intra-group services (continued)

Simplified method

- Presumption that the **benefits test** is satisfied if the MNE meets the documentation and reporting test
- Mark-up of flat 5% for intra-group services (without benchmarking) qualifying for low value-adding services recommended
- A single invoice describing a category of services should be sufficient as long as the documentation and reporting requirements are met
- Proposes the determination of a threshold to be determined by tax authorities to qualify under the simplified method

Determination of charge

- Calculate the following

Step 1

Pool all costs according to the category of services and identify cost centers used in creating the pool

Step 2

Remove from pool costs attributable to services performed by one group entity on behalf of another (direct recharge)

Step 3

Allocate costs in the pool among the group entities through selected allocation key

Step 4

Apply 5% mark-up to all costs in pool

Low value-adding intra-group services (continued)

What the recommendations do not deal with

- Common issues in relation to developing countries not addressed, e.g., cost base, location savings
- Rationale of prescribed mark-up and relation to local country safe harbor norms
- Available comparable information and market benchmarks
- The rationale for being "elective" – when to or not to choose
- Intra-group charges
  - Recognition that excessive intra-group management charges constitute a key BEPS challenge
  - Country tax authorities may opt to introduce a low threshold to contain the application of the simplified method

Implications and way forward

- No consensus on implementation; OECD believes method must be applied on a broad geographic scale
- Suggests that it applies to both inbound and outbound intra-group charges
- Two step implementation suggested with more work to be done in 2016

Conclusion

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