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Topic

Compare BEPS Actions 8 to 10 on Transfer Pricing with "Arm's Length Method" under Article 9 and with OECD's Revised Guidance on "Transactional Profit Split Method".

Will it eventually lead to "formulary apportionment" under the Mutual Agreement Procedure?

Panel

Panel Chairman – Vijay Iyer

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Panelists

- Rahul Mitra (India)
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Outline of the presentation

1. Overview of BEPS Actions 8-10
2. Action 8
   - Profit Split method and certain emerging issues
   - Hard to Value Intangibles (HTVIs)
   - Cost Contribution Arrangements (CCAs)
3. Action 9 - Transfer Pricing – Risk and Capital
4. Action 10 - Other transaction - Low value-adding intra-group services
5. Digital Economy post BEPS

Overview of BEPS Actions 8-10

BEPS – An overview

- The Organization for Economic Co-operation and Development's (OECD) BEPS project has brought about a paradigm change in taxation of cross border transactions, focusing on themes of substance, transparency and coherence
- These themes, coupled with recommendations given in the final OECD reports are driving governments to overhaul their legislations in order to counter base eroding practices of MNEs
- India, being a member of the G20, is one of the most active participants in the BEPS project,
- India has already adopted Action 13 and certain other key guidance; and is keen to adopt other anti-BEPS measures in a phased manner
- Businesses would need to stay up to date with various BEPS related developments that would be taking place
- Realignment of global value chains may be required in order to comply with amended domestic legislation and tax treaties
- This may need to be supplemented with a revised transfer pricing policy

Overview

BEPS Action 8, 9 and 10
Assure that transfer pricing outcomes are in line with value creation

Action 8: Intangibles

- Wider and clearer definition of "intangibles"
- Introduction of a six step framework to analyse transfer pricing aspects of intangibles
- Legal ownership alone does not generate a right to the return generated by the exploitation of an intangible
- Focus on Development, Enhancement, Maintenance, Protection and Exploitation (DEMPE) functions
- Hard-to-Value Intangibles (HTVIs)
- Cost-Contribution Arrangements (CCAs)

Action 9: Risk and Capital

- Focus on conduct of parties and their capability and functionality to manage risks. Assumption of risk without 'control' over that risk is likely to be problematic
- Separate consideration regarding an appropriate return to any cash investment
- Introduction of a six step framework to analyse risks for transfer pricing purposes

Action 10: Other high-risk transactions

- Intra-group services / low value-add services
- Profit Splits Recognition of transactions
- Commodity transactions

BEPS Action 8
Birth of a new Arm's Length Principle

- **Legal ownership** of intangibles, by itself, does not entitle to any remunerations respectively returns from exploiting the intangibles

- The remuneration of each entity performing functions related to the development, enhancement, maintenance, protection and exploitations **(DEMPE)** of the intangibles will depend upon the **relative value** of the contribution, including to what extent they are ***de facto* managing the risk** associated with the intangible.

- Control over risk - Risks should be allocated to enterprise that **exercises control** and has **financial capacity** to assume the risk

- Entities providing simply the funding **without controlling the specific financial risks** are entitled to **no more than a risk-free return** for its funding activities

BEPS Action 8

Current and future approach in determination of transfer prices

BEPS triggers a shift from **“arm’s length pricing”** to **“arm’s length profit allocation”**

- **Current** determination of transfer prices

Functional- and Risk Analysis → Entity Characterization → Method Selection → Determination of Transfer Prices based on Arm’s Length Profits at the level of Routine Entities

- **Future** determination of transfer prices (with respect to risk)?

Analysis of Actual Functions and Risks assumed (“Substance over Form”)

Six-step framework for analyzing risk

1. **Identification of economically significant risks with specificity**
2. **Determination of contractual assumption of the specific risk**
3. **Functional analysis in relation to risk**
4. **Interpreting steps 1–3**
5. **Allocation of risk**
6. **Pricing the transaction, taking into account the consequences of risk allocation**

Determination of Transfer Prices based on (Overall) Profit Allocation

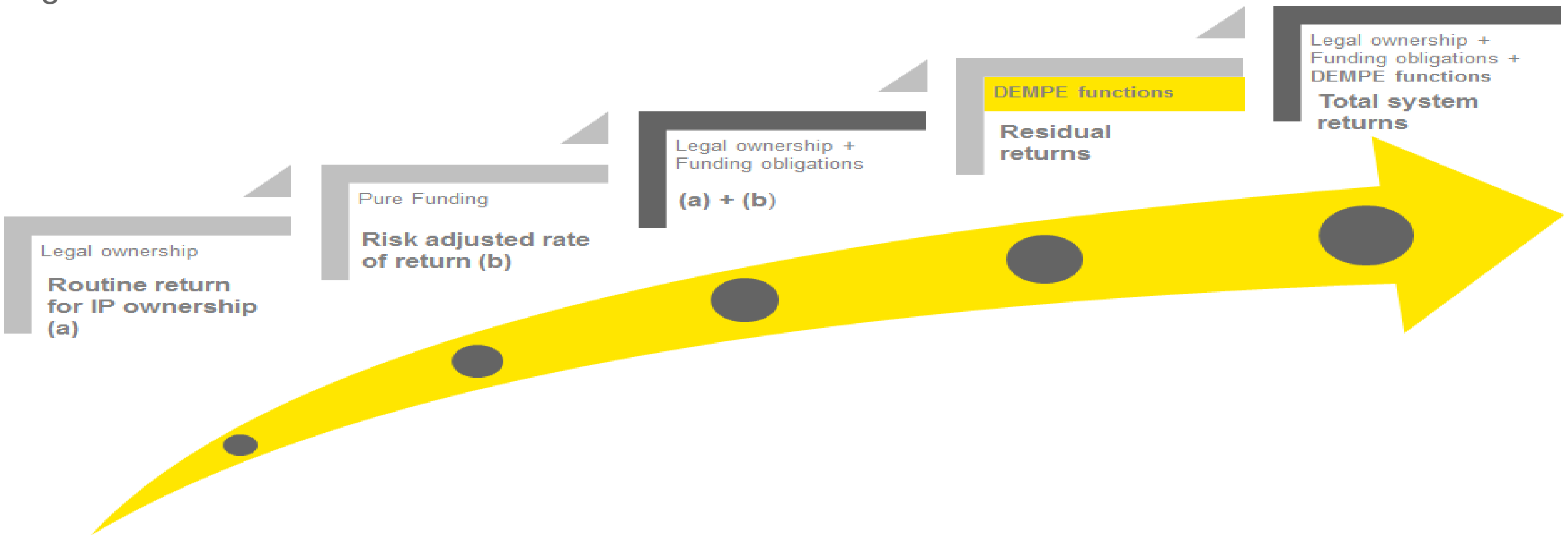
Taking into Account an Arm’s Length Risk Reward

Risks should be allocated to enterprise that **exercises control** and has **financial capacity to assume the risk**

BEPS Action 8
Key principles of income allocation

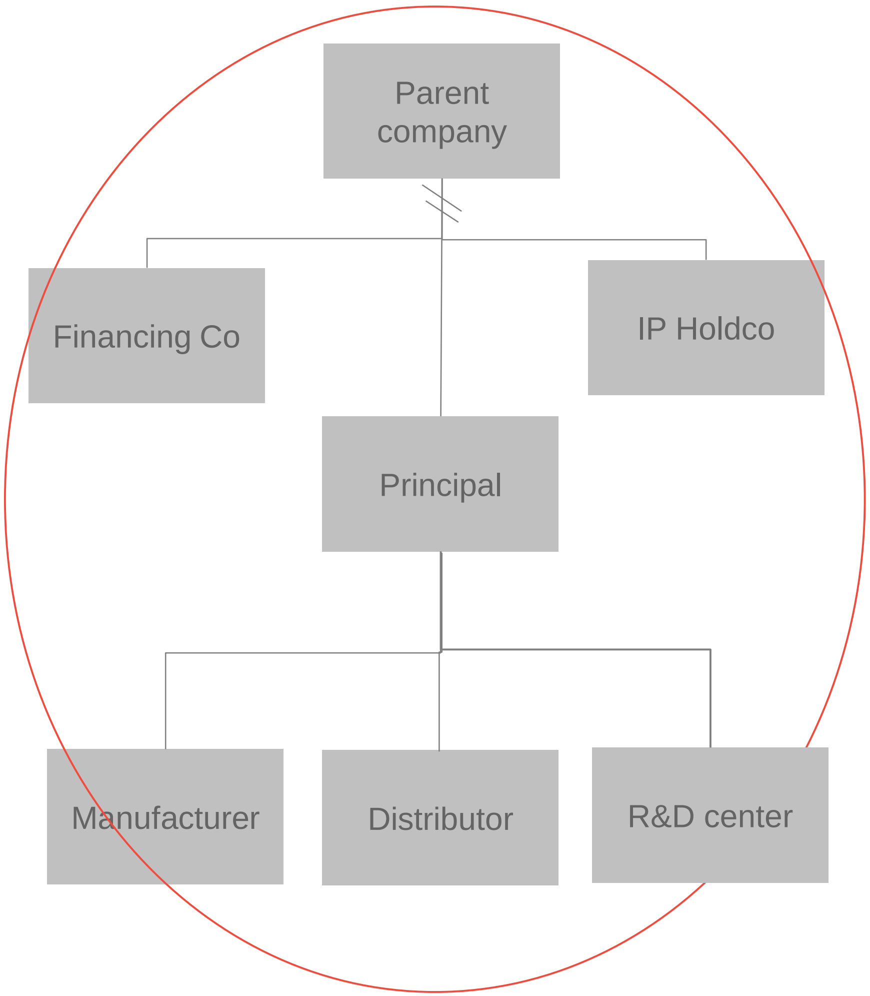
Total system return (profits and loss entitlement)

- Entitlement of profit or loss relating to differences between actual and expected profits will depend on
  1. which entity/entities assume(s) the risks that caused the differences and
  2. whether the entity/entities are performing important functions (DEMPE functions) or
  3. contributing to the control over the economically significant risks
- Not performing any of the DEMPE functions and not exercising control over the financial risk will generate no more than a risk-free return



Actions 8–10

Areas for immediate risk assessment

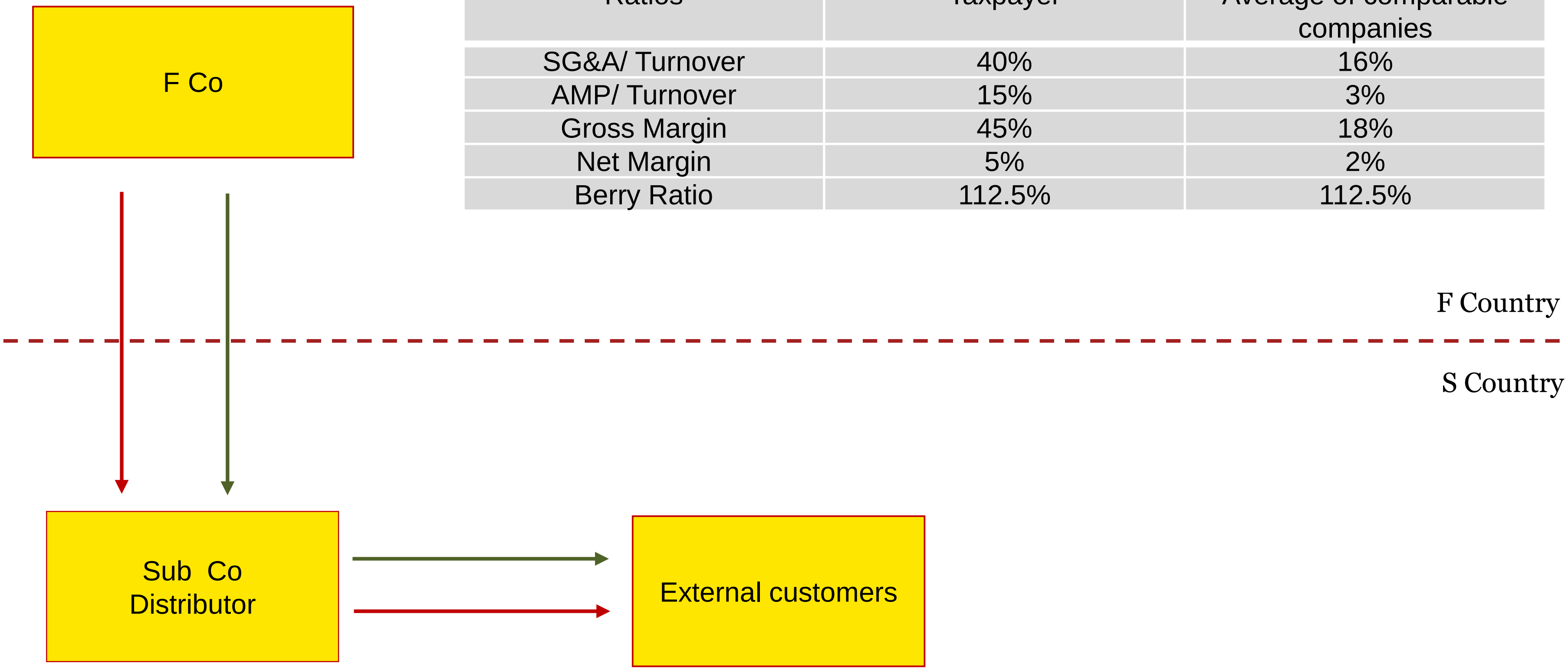


- Shift from the legal form to the economic reality of a transaction
- Contractual allocation of risk without sufficient control will not be regarded
- Profit splits may be used to divide residual income after paying a cost plus remuneration to limited risk entities
- Develop, Enhance, Maintain, Protect, Exploit (DEMPE) functions – who is entitled to intangible-related returns
- More focus on substance, risk-taking activities, comparability, functionality and documentation (legal agreements)

Profit Split Method

Case Study - Distributor

Ratios	Taxpayer	Average of comparable companies
SG&A/ Turnover	40%	16%
AMP/ Turnover	15%	3%
Gross Margin	45%	18%
Net Margin	5%	2%
Berry Ratio	112.5%	112.5%

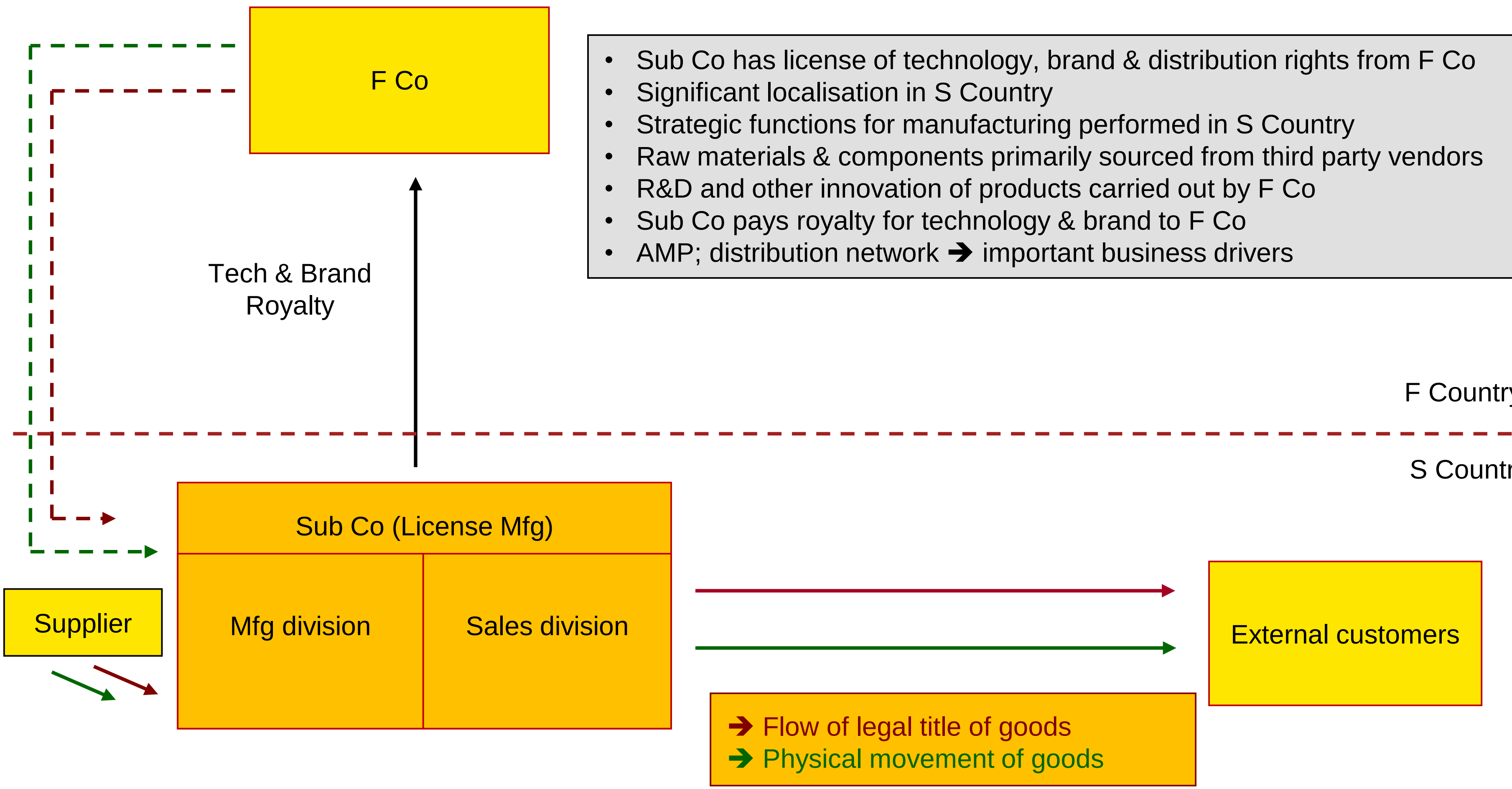


➔ Flow of legal title of goods
➔ Physical movement of goods

- Sub Co has license of brand & distribution rights from F Co
- AMP; distribution network ➔ key business drivers

Case Study - Licensed Manufacturer

- Sub Co has license of technology, brand & distribution rights from F Co
- Significant localisation in S Country
- Strategic functions for manufacturing performed in S Country
- Raw materials & components primarily sourced from third party vendors
- R&D and other innovation of products carried out by F Co
- Sub Co pays royalty for technology & brand to F Co
- AMP; distribution network ➔ important business drivers



Emerging Issues

1. It may be difficult to measure the relevant revenue and costs for all the associated enterprises participating in the controlled transactions, which could require stating books and records on a common basis and making adjustments in accounting practices and currencies.
2. When the transactional profit split method is applied to operating profit, it may be difficult to identify the appropriate operating expenses associated with the transactions and to allocate costs between the transactions and the associated enterprises other activities
3. Depending on the facts of the case, other indicators that the transactional profit split may be the most appropriate method could include a high level of integration in the business operations to which the transactions relate and /or the shared assumption of economically significant risks (or the separate assumption of closely related economically significant risks) by the parties to the transactions. **It is important to note that the indicators are not mutually exclusive and on the contrary may often be found together in a single case**
4. The Revised Guidance points to employee compensation as an appropriate profit splitting factor for trading profits. The basis for this is that the performance of trading personnel, particularly traders, risk managers, specialised marketers, the so-called "front office" high-value functions, is critical to the profitability of global trading and, as a result, compensation of these functions is generally related to performance and value add. The revised guidance does not provide for the meaning of performance related compensation and relevance of adjustments.
5. How latest development such as master file and local file compliance would help the tax authority in determining profit split factor

Emerging Issues

7. Unavailability of comparable data is one of the basic premises of applicability of PSM. However, while applying contribution analysis, the division of profits is to be determined or supported by comparable data (External Data). This appears to be a contradiction.

8. In determining the relevant profits, it is essential to first identify and accurately delineate the transactions to be covered by the transactional profit split method, and from this identify the relevant income and expense amounts for each party in relation to those transactions. This might turn out to be a complex exercise. Further, the availability of information of the financial information

9. What are the factors which one should consider in determining whether the profit to be split should be gross profit or operating profit?

10. The meaning of operating profit and gross profit is not specifically provided and therefore, may be interpreted differently by tax payer and tax authorities.

11. While using assets based profit splitting factors, what all assets should be taken into consideration? What should be the treatment of self-developed intangibles and other intangibles already depreciated which may not be reflected on the balance sheet at all?

11. Whether market would also be an intangible? If no weightage is given to market then it would not be acceptable by the developing countries such as India, China, Brazil etc.

12. While using cost based profit splitting factors, what all costs should be taken into consideration? Guidance on allocation of indirect cost is not available

13. When you split profit, whether losses should also be split. No guidance is available on the same.

Action 9 - Transfer Pricing for Risk & Capital

Action Plan 9 – Aligning Transfer Pricing outcomes with value creation

Identify the economically significant FAR

Contractual FAR

Ascertain Conduct

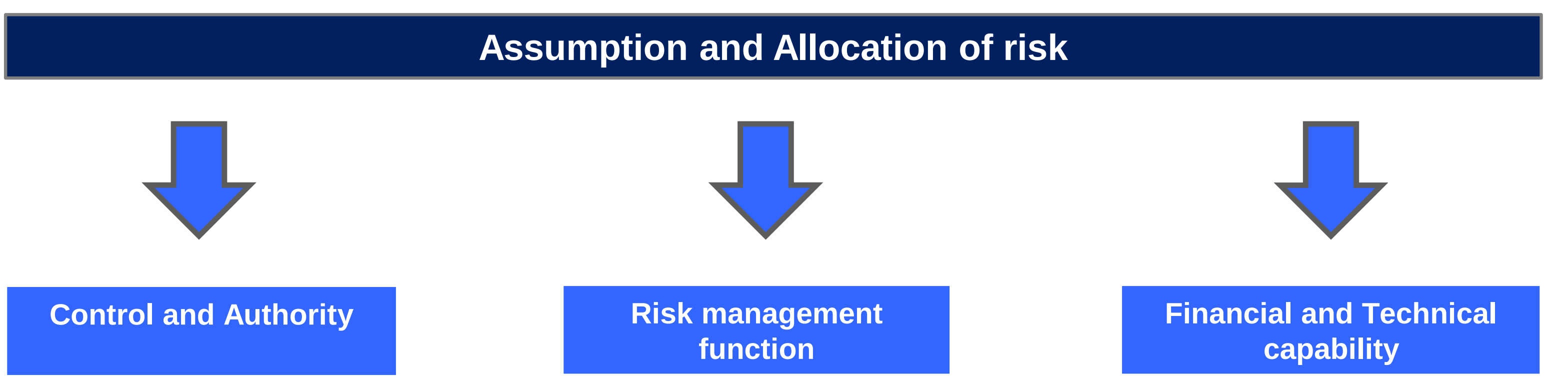
Allocation of FAR as per Conduct

TP Analysis based on conduct

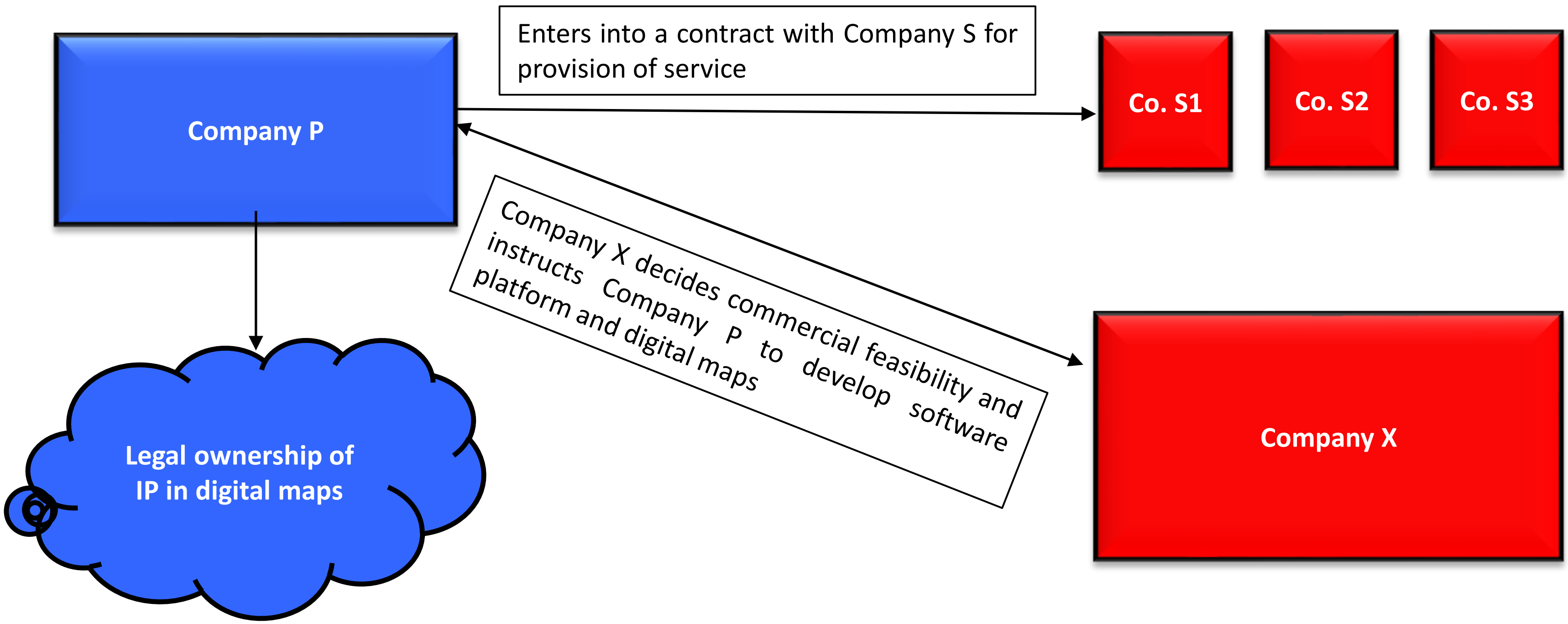
Commercially irrational transactions to be disregarded

Action Plan 9 – Aligning Transfer Pricing outcomes with value creation

- Emphasis on the need to accurately delineate a transaction and to ensure that the actual conduct of parties is reflected in contractual arrangements
- Transactions can be disregarded for TP purposes where they lack commercial rationality
- Contractual allocations of risk to be respected only when they are supported by actual decision-making i.e. exercising control over these risks coupled with financial capacity to assume such risks
- ‘Cash boxes’ or entities merely providing funding without performing significant activities - entitled only to risk-free returns to the extent of their capital contributions, if they have no de-facto control on the associated risks



Ownership and Operating Structure (Risk example)



Mechanics of structure

Company P	• Invests in development of software platform based on inputs from Company X • Produces digital maps (i.e. map data) for countries as per demand in various markets, as specified by X • Legal owner of the IP in software platform and in map data.
Company X	• Identifies commercial opportunities for the map data / digital maps developed by Company PE. • Provides specifications on the features to be built into the software platform. • Instructs company P to develop software platform and digital maps of various countries based on survey / research of customers • Has a product development division which decides on which countries to target, and the technology to rely upon (i.e. 2D, 3D and 4D) • Maps based on research and survey done in various countries through outsourced centers
Companies S1, S2, S3	• Develops marketing and sales strategies • Markets the digital maps to various third party customers (e.g. OEM manufacturers, auto manufacturers, mobile service providers) • Negotiates contracts with 3rd party customers • Ensures map data is installed appropriately on customers servers

Questions to ponder

Key concerns

1. What are the economically significant risks?

2. Who assumes and controls economically significant risk for developing software platform and IP map data?

3. Who assumes and controls economically significant risk for exploiting IP in map data?

4. What should be the remuneration model for Company P?

5. What should be the remuneration model for Company S1, S2, S3

6. Who should bear the risk for upside and downside of commercial opportunities created from sale of IP in map data?

Conclusion

Company P contractually assumes the economically significant risk of investment, production and sale of digital map data…

Based on the conduct, Company X and Companies S1, S2, S3 have the control and the capability to assume the said risks

Digital Economy

Description of the case

Nexus (value creation) & profit attribution (AOA)

Does BELLA CO **create value** in India?

Who are the **significant people functions** in India?

What **assets** and **risks** can be attributed to BELLA CO in India?

How much **profits** can be attributed to BELLA CO in India?

Profit attribution

	No physical presence	Server automatically collecting the data	Active customers provide low-value services	Active customers provide medium-value services	Active customers provide high-value services
Internal dealing (i.e. services provided)	N/A	Data collection services	Data collection services	Data collection services + ideas (considered not highly valuable)	Data collection services + ideas (considered highly valuable) + marketing services
FAR	SPF: N/A Assets: N/A Risks: N/A	SPF: N/A Assets: Relevant data Risks: N/A	SPF: Active customers? Assets: Relevant data Risks: N/A	SPF: Active customers? Assets: Relevant data Risks: N/A	SPF: Active customers? Assets: Relevant data Risks: N/A
TP Method	N/A	TNMM (benchmark unrelated data collectors)	TNMM (benchmark unrelated data collectors), median	TNMM (benchmark unrelated data collectors), upper quartile	CUP/TPSM? Valuation relevant data (internal and external?), but also allocate costs (at value) of collection, elaboration and exploitation of data
Profit attribution	N/A	Routine	Routine	Routine+	Residual?

Conclusions

- Not possible to ring-fence the “digital economy” topics
- Digital PE without changing how to interpret the ALP might not produce any significant result
- TP and ALP can be a solution
- Need to change some concepts on how to implement the ALP (e.g. active users contribution being “unconscious” contributors (→ SPF) in the broader value creation)
- TPSM could be applied based on the relevance of the users participation in the specific business model

Application to Action 8 to:

- Hard to Value Intangibles (HTVIs)
- Cost Contribution Arrangements (CCAs)

Hard to Value Intangibles (HTVIs)

Definition

The term hard-to-value intangibles (HTVI) covers intangibles or rights in intangibles for which, at the time of their transfer between associated enterprises,

(i) no reliable comparables exist,

(ii) at the time the transactions was entered into, the projections of future cash flows or income expected to be derived from the transferred intangible, or the assumptions used in valuing the intangible are highly uncertain, making it difficult to predict the level of ultimate success of the intangible at the time of the transfer

1. Tax administrations can consider outcomes post the deal/ transfer (ex post) as presumptive evidence about the reasonableness of the assumptions of the valuation undertaken before the deal/ transfer (ex ante) of intangibles.
2. Incorrect to base the valuation on the actual income or cash flows without taking into account whether the associated enterprises could or should reasonably have known
3. If the intangible was transferred at an undervalue or overvalue - compared to the ALP, the revised price of the transferred intangible may be assessed to tax taking into account price adjustment clauses and/or contingent payments, irrespective of the payment profiles asserted by the taxpayer.
4. Tax administrations should apply audit practices to ensure that presumptive evidence based on ex post outcomes is identified and acted upon as early as possible.

Cost Contribution Arrangements

- **Meaning**: contractual arrangement where contributions and risks are shared in the expectation of mutual benefit
- New guidance on control of risk, and intangibles transactions also applies to CCAs
- **New requirement**: every CCA participant must have functional capacity to exercise control over risks associated with risk-bearing opportunity in a CCA
- Value of contributions must be in proportion to reasonably anticipated benefits, otherwise true-ups may be required
- Contributions should be measured based on value, not cost
- Where the difference between the value and costs is relatively insignificant, for practical reasons current contributions of a similar nature may be measured at cost for services CCAs

Before BEPS

- Cost permitted as value

After BEPS

- Cost not permitted as approximation of value

HTVI (contd..)

BEPS action 8 provides that ex-ante outcome cannot be challenged over ex-post outcome, if at least one of the following conditions is met by the taxpayer:

- Taxpayer provides:
  - details of the ex-ante projections used at the time of the transfer, including how risks were accounted for, and
  - evidence that any significant variations between projections and actual outcomes are due to unforeseeable developments or events
- Any significant difference between the financial projections and actual outcomes does not increase or reduce the value of the HTVI by **more than 20%** of the compensation determined at the time of transaction
- An initial commercialisation period of five years has passed and the difference between the projected and actual projections **was not greater than 20%** in the following period (to take account of second or third use of the intangible)

Low value-adding intra-group services

Management services

Headquarters (HQ)

Central support functions

Management services →

← Service fee

India Operating Company (OpCo)

Operations

BEPS intention

Consider member countries' concern that excessive management fee charges result in base erosion and profit shifting

To provide for a simplified approach for low-value adding services to reduce compliance efforts and to provide taxpayers with certainty of acceptance

- For efficiency reasons, the group has centralized support functions in the HQ. These support functions include, accounting and auditing, planning and budgeting, internal audit, human resources (HR), information technology (IT), communication, tax and legal, group strategy, global production planning, R&D, central procurement, global sales and treasury
- Service fees are consistently computed on the basis of full service costs plus a mark-up of 10% using a sales key to allocate service costs to OpCo's, including India OpCo

What will change for management services?

Base Erosion and Profit Shifting

1

BEPS guidance

For ***"low-value adding services,"*** a simplified charge mechanism is suggested but is **subject to adoption by countries.** The guidance provides for the following:

- Definition of (low-value adding) service cost
- A profit mark-up of 5% shall be applied without further benchmarking support
- The tax authorities should refrain from reviewing or challenging the benefit test in the form of a mere description in the TP documentation
- The tax authorities should only examine benefits by categories but not on a specific charge

In contrast, for ***"high-value adding services"*** this implies:

- Potential perception that a mark-up of 5% would not suffice;
- Benchmarking based on detailed function and risk analysis
- Detailed benefit test required/ likely to be requested, in particular in respect to indirect charging
- Comparable Uncontrolled Price (CUP) method preferred; in case of costs-based methods, consideration whether cost base requires amendment

2

Implications

- Safe Harbour rules (SHRs) recently amended to include "Low-value add services"
- Companies may be subject to rigorous documentation requirements / detailed scrutiny in India on such charges, if not covered by SHRs
- Services provided by an outsourced service provider in India – low-value add vs. high-value add

3

Action steps

- Consider opting for Safe Harbour for low-value added services
- Continue maintaining detailed documentation or enhancing/ strengthening documentation service transactions
- Consider the impact of deviation in the global TP policy for India transactions
- Consider use of APAs

Conclusion - Five steps to consider

1	**Refresh the assessment of your TP risk profile** Examine your structure and model to identify where your greater areas of risk lie and devote your resources and focus accordingly
2	**Update your risk mitigation and compliance activities** Prepare robust and contemporaneous documentation in support of TP policies and strategies. Consider whether the substance within relevant points in your model needs to be modified to meet the new BEPS requirements
3	**Develop a comprehensive audit plan** Develop a plan, including knowing what data is available and can be produced, to respond to inquiries and audits Consider using APAs and other agreements with tax authorities where appropriate Conceive a methodology for consistently answering queries from various tax authorities
4	**Revisit TP policies** Re-examine inter-company arrangements at the most potential risk in light of the new BEPS standards, such as those involving buy-sell distributors, IP transactions and inter-company loans
5	**Realign your TP and IT systems** Evaluate the available tools for aligning TP and IT and reporting systems Develop the automation needed to monitor TP results as close to real time as possible to reduce errors and unusual results, which attract the attention of tax authorities

Thank you!