Case Study 1&2

Case Study 1 – Attribution of profits to dependent agent PE

- I Co is an Indian subsidiary of F Co, a foreign company.
- I Co acts as an agent of F Co, securing orders/ concluding contracts from Indian customers on behalf of F Co.
- I Co performs "debtor functions" on behalf of F Co, however does not perform any "inventory functions".
- I Co incurs annual operating costs worth US$ 6 million; and earns mark-up @ 20% on operating costs from F Co.
- Annual fees received by I Co from F Co ➔ US$ 7.20 million [6 + (20% of 6)].
- F Co sells products worth US$ 6 billion directly to customers in India on offshore basis.
- I Co constitutes DAPE of F Co; and thus need arises to attribute profits to DAPE.
- DAPE being a proxy for "commensurate" distribution functions, Revenue Officer conducts economic analysis; and identifies comparables, reflecting following average financial results :

Sales	100.00
Less : Cost of goods sold	80.00
Gross Profits (GP Margin ➔ 20%)	20.00
Less : Operating Expenses (OE/ Sales ➔ 17%)	17.00
Net/ Operating Profits or Return on Sales (OP Margin ➔ 3%)	3.00
Return on operating expenses [dialect of Berry Ratio] - [3.00/ 17.00 x 100]	17.65%

Case Study 1 – Attribution of profits to dependent agent PE .. (contd.)

- At 3% ROS, following profits get attributed to DAPE of F Co :

Particulars		US$ in million
Sales of F Co (DAPE)	(A)	6000.00
Profit attribution to DAPE @ 3% ROS	3% of (A) = (B)	180.00
Operating expenses (OE) of I Co/ DAPE	(C)	6.00
Profit reported by I Co	20% of (C) = (D)	1.20
Additional Profit Attribution to DAPE (final adjustment in hands of F Co)	(B) – (D) = (E)	178.80
Resultant return on operating expenses (dialect of Berry Ratio)	(B)/ (C) x 100	3000%

- At 1% ROS, following profits get attributed to DAPE of F Co :

Particulars		US$ in million
Sales of F Co (DAPE)	(A)	6000.00
Profit attribution to DAPE @ 1% ROS	1% of (A) = (B)	60.00
Operating expenses (OE) of I Co/ DAPE	(C)	6.00
Profit reported by I Co	20% of (C) = (D)	1.20
Additional Profit Attribution to DAPE (final adjustment in hands of F Co)	(B) – (D) = (E)	58.80
Resultant return on operating expenses (dialect of Berry Ratio)	(B)/ (C) x 100	1000%

Case Study 1 – Questions for Panellists

- Should attribution of profits to DAPE be made with reference to economic analysis carried out by Revenue Officer, yielding exorbitant Berry Ratio ?
- Given low level of intensity of functions (OE/ Sales) of DAPE of F Co (0.10%), should any revenue linked analysis be sanitized with reference to Berry Ratio (GP/ OE) or dialect of Berry Ratio (OP/ OE) ?
- If yes, arm's length OP/ OE of comparable distributors selected by Revenue Officer is 17.65%, as against 20% of DAPE ➔ should there be no further profit attribution to DAPE ?
- Is such comparison fallacious, as IOF of DAPE is 0.10%, as against IOF of 17.65% of comparable distributors, i.e. IOF of comparable distributors is 176.50 times than that of DAPE ?
- Should comparable distributors with more or less similar level of IOF of DAPE be selected ?
- If no comparable distributors are available at such low level of IOF (0.10%) ? ➔ should "arithmetical adjustments" be made to GP margin [20%] of comparable distributors with reference to difference between IOFs by 176.50 times ? :
  - Adjusted arm's length GP margin ➔ [20/ 176.50] ➔ 0.11%
  - Arm's length Gross Profit on turnover of US$ 6 billion ➔ US$ 6.60 million
  - Arm's length Operating Profit of DAPE [6.60 – 6.00] ➔ US$ 0.60 million
  - Actual Operating Profit of DAPE ➔ US$ 1.20 million
- No further profit attribution to DAPE ?
- Is "arithmetical adjustment" a meaningful exercise ?
- Should advanced statistical analysis with reference to regression analysis be carried out to identify arm's length profit level indicators at given level of IOF of DAPE ?

Case Study 2 – Distribution functions & marketing intangibles

Principal Co

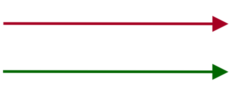
Ratios	India Sub Co	Average of comparable companies
SG&A/ Turnover	40%	16%
AMP/ Turnover	15%	3%
Gross Margin	45%	18%
Net Margin	5%	2%
Berry Ratio	112.5%	112.5%

FOREIGN

INDIA

India Sub Co

Distributor



Customer

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

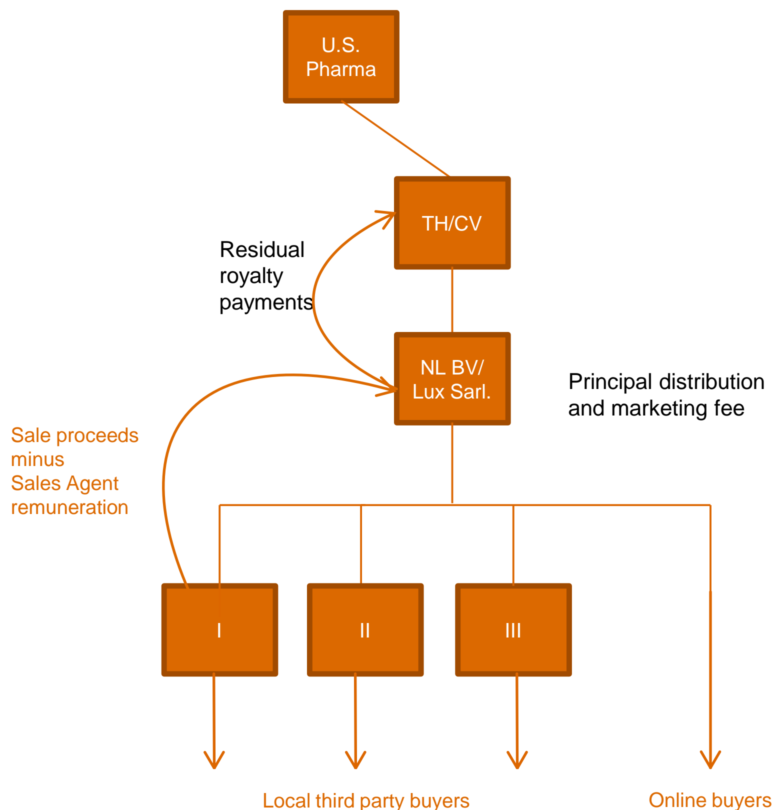
Case 2 – Questions for Panellists

- How to identify whether selling & distribution functions contribute to unique/ non routine marketing intangibles :
  - Stand-alone analysis of supply chain of taxpayer, having regard to uniqueness of industry ?
  - Qualitative analyses of functions performed by taxpayer & comparables ? Would sufficient data exist for comparables ?
  - Quantitative analyses of functions performed by taxpayer & comparables ? Filter ➔ AMP or SG&A expenses ?
  - Combination of all the above aspects ?
- If selling functions are found to contribute to unique/ non-routine marketing intangibles, :
  - Should residual profit split method (RPSM) be adopted with respect to system profits relating to Indian sales ?
  - Can economic adjustments, say using regression analysis, be made to even out differences, albeit involving presence of unique/ non-routine intangibles ?
  - Can a simple mathematical solution of higher "spend" on AMP/ SG&A, along with mark-up, being subsumed within higher distribution rewards of taxpayer, be the answer ?

Case study 3 -intangibles

Case study 3: Intangibles

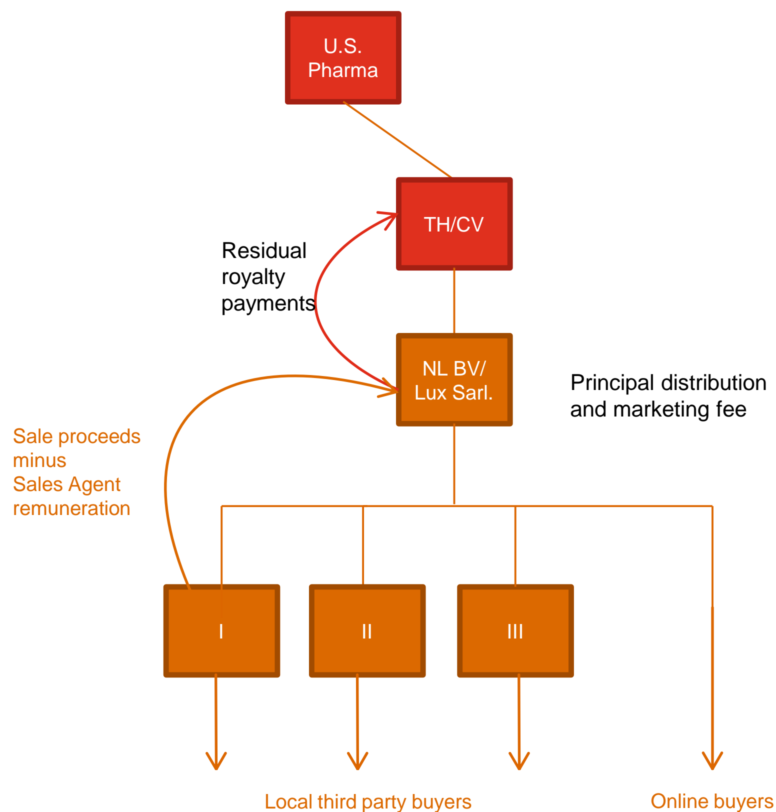
Initial structure



Factual background

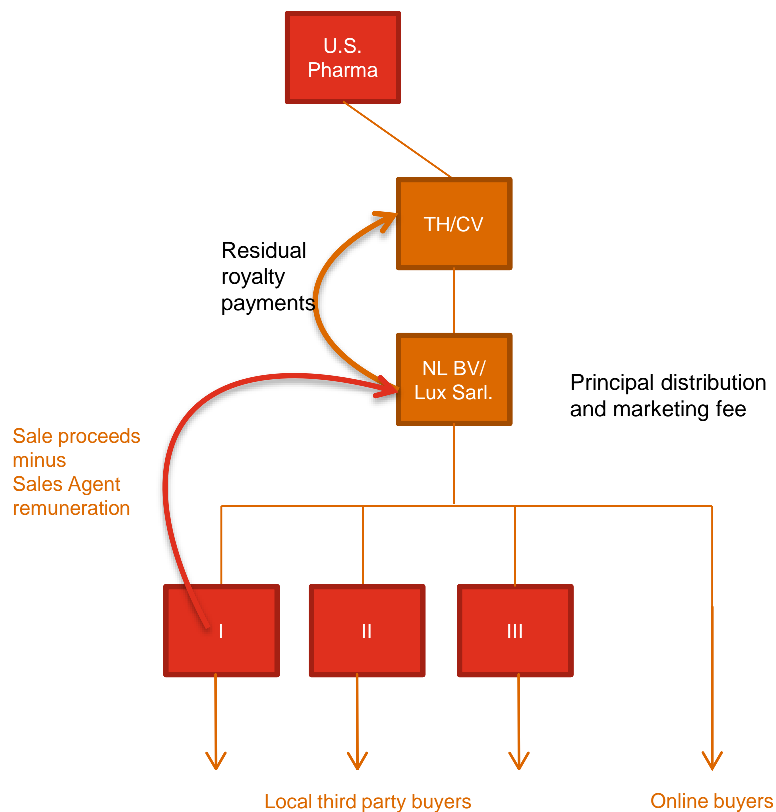
- U.S. Pharma and CV have developed a new medicine.
- They shared development costs 70/30 by entering into a cost sharing agreement.
  - U.S. Pharma is owner of the U.S. patents
  - CV is owner of the rest of the world patents
- NL BV is the principal sales/distribution and marketing company for the sales of the new medicine in Europe and Asia.
- NL BV reports an arm's length remuneration (TNMM - PLI: turn over); NL BV pays a residual royalty to TH/CV.
- Sales Agents I-III sell the medicine to local third party buyers in each specific country I – III.
- The medicine is also sold online in various other countries.

Case study 3 : Intangibles



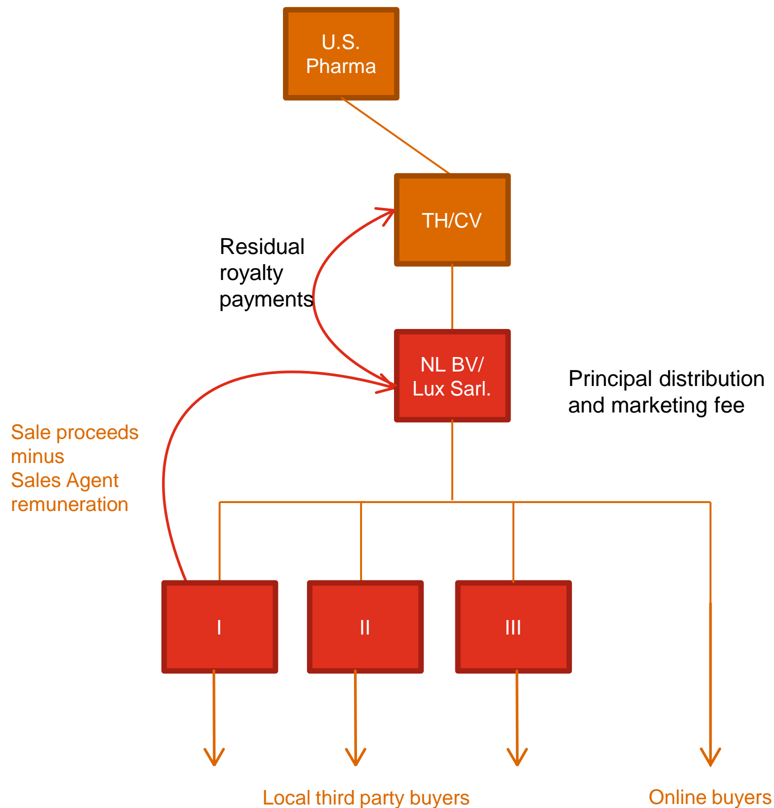
- Points of attention:
- Remuneration of companies I – III
- Application of the treaty with respect to payments made by companies I – III
  - BEPS Action 15/MLI
- Risk of PE of NL BV in countries I - III
  - BEPS action 7
- Taxation of NL BV/CV profits in countries of online buyers
  - BEPS action 1/Pillar I

Case study 3 : Intangibles



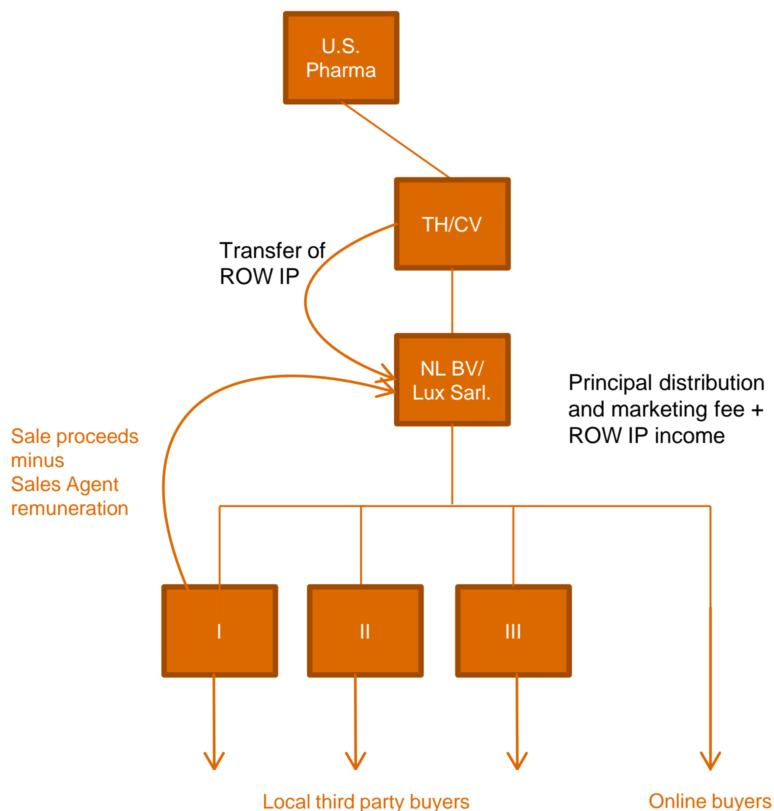
- Points of attention:
- Deductibility of residual royalty
  - Arm's length payment?
  - BEPS action 2/hybrid mismatches
- Dutch dividend tax on distributions by NL BV
- Dutch conditional withholding tax on interest/royalties to low tax jurisdictions

Case study 3 : Intangibles



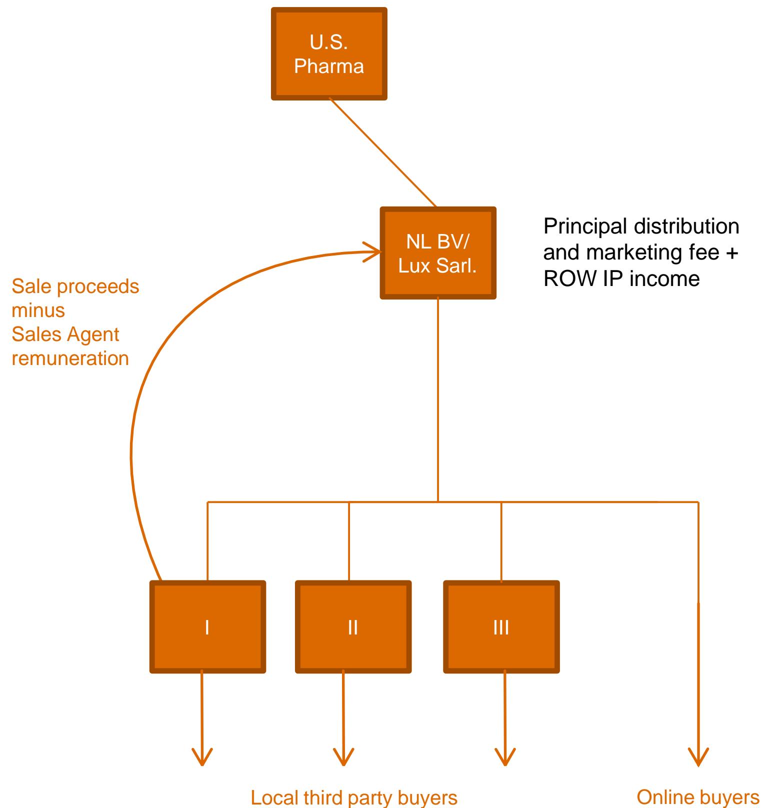
- Points of attention:
- Taxation at US TopCo level
  - CFC/GILTI
- Compliance/documentation/transparency
  - BEPS action 13/CbCR

Case study 3 : Intangibles



- Due to the international tax developments, the group decides to transfer the ROW IP from CV to NL BV.
- NL BV will not only own the ROW IP, but also be the principal sales/distribution and marketing company for the sales in Europe and Asia.
- CV is either liquidated, or also checked as a transparent entity from a US tax perspective.

Case study 3: Intangibles



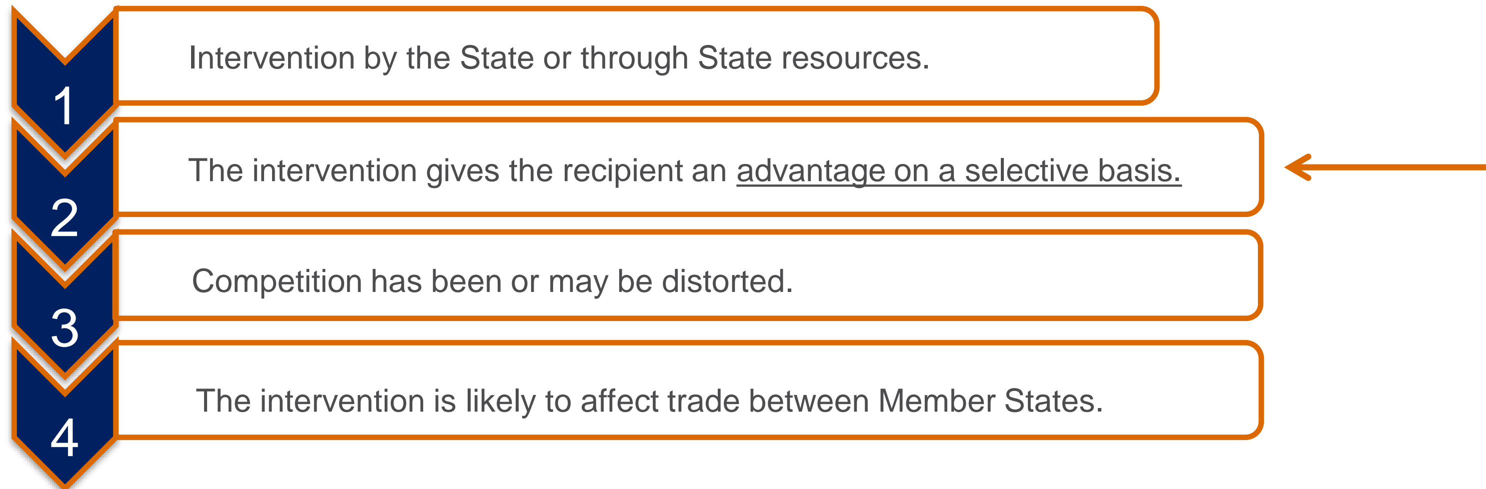
- Transfer of intangibles through on-shoring to a high taxed country such as the Netherlands

- How to value the intangibles?
  - Discounted Cash Flow
  - Arm's length principle
  - Hard to value intangibles
  - DEMPE functions

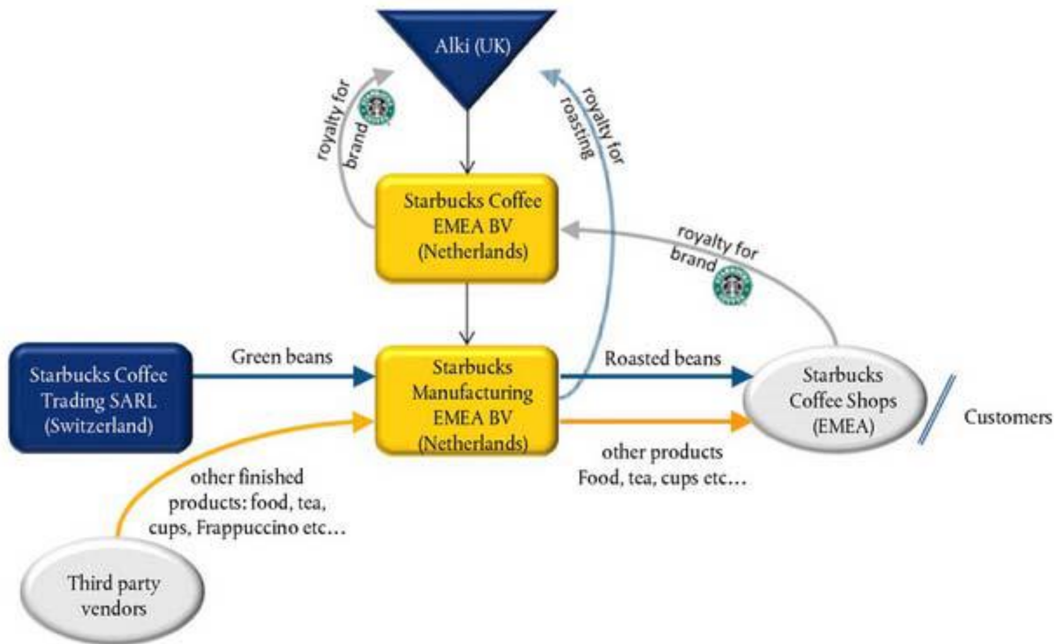
- Effect on previously mentioned points of attention?

Latest EU State Aid Developments

4 conditions for the existence of State aid



EU General Court annuls EC’s decision



Source: Judgment of the General Court of European Union of 24 September 2019, Joined Cases T-760/15 and T-636/16, The Netherlands and Starbucks Corp/Starbucks Manufacturing Emea BV versus Commission, ECLI:EU:T:2019:669.

- **Can the EC check whether the intra-group transactions were priced as if they were negotiated under market conditions (141-156)? → Yes**
  - If the domestic law of a Member State does not make a distinction between taxing integrated undertakings and stand-alone undertakings, that law is intended to tax the profit arising from an economic activity from this integrated undertaking as though it had arisen from transactions carried out at market prices (149).
  - Therefore, in such a situation, the EC can check whether the pricing that is accepted for such an integrated undertaking, equals the pricing that would have been negotiated at market conditions, or whether the accepted pricing gives the specific integrated undertaking an advantage that could constitute State aid (149 - 156).

- **The arguments of the Netherlands and Starbucks do not lead to a different conclusion (156-172).**
  - Member States have the autonomous right to levy tax, but the EC has the right to investigate whether the way the Member States exercise this right may constitute State aid.
  - The EC does not have the autonomous right to determine what the "normal" taxation of integrated enterprises is, without taking into account the domestic tax laws of the Member States.
  - If the domestic laws of a Member State determine that integrated enterprises must be taxed under the same conditions as independent enterprises, the EC has the right to check whether the accepted pricing is in line with the pricing that would have resulted from market negotiations (159).

- **Whose ALP is it, anyway?**

- The EC raised six errors justifying the conclusion that SMBV was given a selective advantage through the APA. (53)

- **Principal position**:

EC considered that the accepted TP method could not result in a reliable outcome in line with the ALP.

1) Choice of the TNMM and the lack of examination of the intra-group transaction for which the APA had in reality been requested.
2) The CUP method should have been applied in order to determine the amount of the royalty paid by SMBV to Alki; under that method, the royalty should have been zero.
3) Annual determination of the costs of green coffee beans.

- **Subsidiary position**:

EC considered that, even assuming that the TNMM were the appropriate method, the TP report had incorrectly applied the TNMM.

4) Identification of SMBV as the most complex entity.
5) Analysis of SMBV's functions and determination of SMBV's profit on the basis of operating costs.
6) Choice of adjustments.

Argumentation EUGC

Lack of examination of intra-group transaction for which APA had been requested (200-204).

- The mere finding of a methodological error does not suffice to demonstrate that the APA conferred an advantage on SMBV (201).
- The EC wrongly found that the absence of separate analyses of the royalty in the TP report and in the APA conferred an advantage on SMBV (205).
- The TP report did not disregard the SMBV – Alki license agreement (204).

Argumentation EUGC

Choice TNMM (206-216)

- According to the Dutch TP Decree, the DTA must always conduct a transfer pricing audit from the perspective of the method adopted by the tax payer at the date of the transaction. The tax payer does not have to evaluate all methods to justify why a certain method is chosen over another one (214).
- The CUP method should not be given priority, in principle, above TNMM to approximate market prices (215).

Argumentation EUGC

Royalty should have been zero (217-373)

- In determining whether the royalty should be nil, the EUGC takes the following 5 aspects into consideration (based on arguments brought forward by the EC/NL/Starbucks)(231):
  1) **SMBV's royalty related functions.**
  2) **Can the EC base its analysis on evidence that was not available when the APA was concluded.**
  3) **Who exploited the roasting IP.**
  4) Comparison with coffee roasting agreements concluded by Starbucks with third parties and against similar license arrangements "on the market".
  5) The royalty should have been nil or lower than agreed upon in the APA.

- The EUGC determines with respect to these 5 aspects:
  1) SMBV is not a toll manufacturer or supplier, but roasts coffee for its own behalf and acts as a vendor. (236)
  2) EC cannot base its analysis on information which was not available or could reasonably be foreseen at the time the APA was concluded. (251)
  3) The EC erred in concluding that IP can only be exploited by the party who sells the product tot the final customer and that it would not be rational for the roaster/coffee producer to exploit the roasting IP when it does not market the product directly (258). The IP is also exploited by a party such as SMBV, who is active as a seller on the wholesale market. (264, 265) The EC has not demonstrated that SMBV generated a loss on its roasting activities since 2010, which would not have permitted it to pay a royalty for the roasting IP. (278)

Argumentation EUGC

Royalty should have been zero (217-373)

- In determining whether the royalty should be nil, the EUGC takes the following 5 aspects into consideration (based on arguments brought forward by the EC/NL/Starbucks)(231):
  1) SMBV's royalty related functions.
  2) Can the EC base its analysis on evidence that was not available when the APA was concluded.
  3) Who exploited the roasting IP.
  4) **Comparison with coffee roasting agreements concluded by Starbucks with third parties and against similar license arrangements "on the market".**
  5) **The royalty should have been nil or lower than agreed upon in the APA.**

- The EUGC determines with respect to these 5 aspects (*cont'd*):
  4) The EC has not demonstrated that the royalty should have been zero by applying the CUP method on the basis of a comparison with contracts concluded between Starbucks and 10 third party manufacturing companies. (346)

     The contracts of three competitors of Starbucks with unrelated coffee roasting companies are not comparable and can thus also not be used to demonstrate that the royalty should have been zero. (358)
  5) The EC did not indicate at which lower amount the royalty should have been set. (362) Although the variable nature of the royalty raises questions regarding the economic rationality, this does not preclude the royalty from corresponding to its economic value, provided all parameters used to determine the variable royalty were correct. (366 + 367)

Argumentation EUGC

Annual determination of the costs of green coffee beans

- The pricing of the green coffee beans did not form part of the APA and the EC has not demonstrated the Netherlands granted SMBV an advantage by excluding this from the APA. (386 – 391)

Argumentation EUGC

Identification of SMBV as the most complex entity

- The TP Guidelines do not oblige choosing the least complex entity, but merely advocate choosing the entity for which the most reliable data are available. (434)
- If SMBV was not the least complex entity, that does not automatically lead to the conclusion that the pricing would be wrong and that thus an advantage would be granted to SMBV. (436)

Argumentation EUGC

Analysis of SMBV’s functions and determination of SMBV’s profit on the basis of operating costs

- The EC has not demonstrated that the choice of the profit level indicator was incorrect. (475)

Argumentation EUGC

Choice of adjustments

- Starbucks made two corrections to the benchmark findings in the TP report:
  - A correction on the cost base
  - A correction in the working capital

- The EC has not demonstrated that the exclusion of the costs of third party company 1 in the TP report conferred an advantage on SMBV. (531)

- The EC has not demonstrated that the validation of the working capital adjustment (relating to the exclusion of the costs of third party manufacturing company 1 in the TP report) by the APA conferred an advantage on SMBV. (548)

- Finally, the EUGC also decides that the EC has not demonstrated that the APA derogated from article 8b and the transfer pricing decree.

EU General Court confirms EC's decision.

Fiat / recap

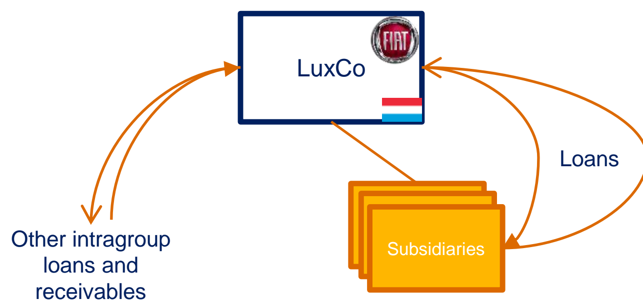
- Factual background

- Concerns a Luxembourg intragroup financing company which also held participations
- Tax ruling of 2012 confirmed the arm's length character of the company's remuneration for its activities
  - Claimed to comply with OECD TP guidance

- State aid procedure

- European Commission challenged transfer pricing
  - Eventually accepted the chosen TP method…
  - … but identified several methodological mistakes which resulted in a too low remuneration → too low tax base
- Negative decision with recovery
- General Court confirmed the Commission's decision

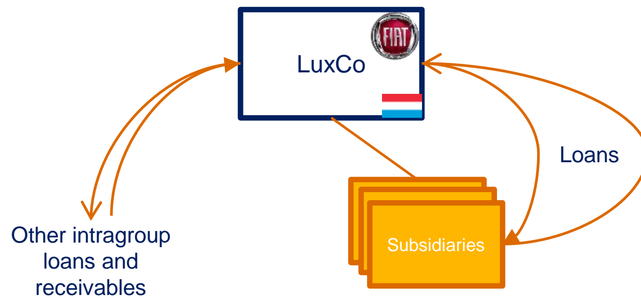
What the EU General Court says on transfer pricing (1/3)



The judgement, as in Starbucks.

- Commission is entitled to review tax rulings (including on TP) and to enforce an arm's length principle under EU State aid rules (138-143, 148)
- In case TP is concerned, there can be an advantage only if the difference between two comparables (controlled party vs. a third party acting at market terms) "*goes beyond the inaccuracies inherent in the [TP] methodology used*" to approximate an arm's length outcome (144)
- Scope of EU GC review: check whether the errors identified by the Commission to conclude to the existence of an advantage meet the above criterion (207)

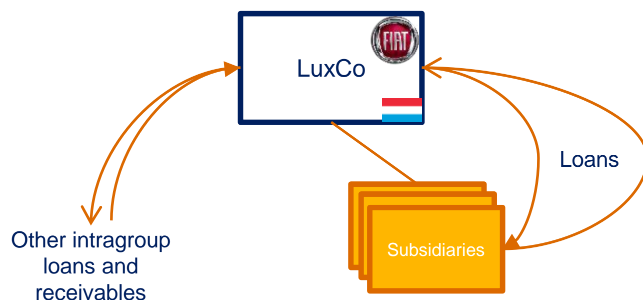
What the EU General Court says on transfer pricing (2/3)



Arm's length principle

- No clear statement that article 107(1) TFEU entails an "EU" arm's length principle, but in effect it is the outcome (150-154)
- EU GC does not look into Luxembourg administrative practice and accepts that group companies and standalone companies are in a comparable situation in view of the objective of the Luxembourg Income Tax Law (also relevant for selectivity analysis) (141-142, 361)
- OECD TP Guidelines can be used to concretely apply the arm's length principle (methodology, etc.) even though they are formally not binding (147)
- Same finding of advantage if using only art.164(3) of the Luxembourg Income Tax Law as reference framework (296-297)

What the EU General Court says on transfer pricing (3/3)



Determination of equity remuneration

- The Fiat Luxembourg financing company had split its equity in three parts: (i) an equity deemed at risk in relation to the financing activity, (ii) equity financing its participations, and (iii) equity remunerated for the functions performed by the company
- The General Court upheld the Commission's finding that this split of equity was artificial and inappropriate
  - In case of problem, all equity is at risk and can be lost
  - No OECD or Luxembourg guidance contemplates the split for purposes of remunerating equity at risk
- Potential impact for Luxembourg companies cumulating holding and financing activities (like LuxCo, on the left-hand chart) – Fiat's approach is widespread on the market
- Limited recourse clauses as potential solutions to back up the position that equity at risk is not the full equity?

Swiss Federal Court: Decision of December, 2018

Swiss Federal Court: Decision of December, 2018

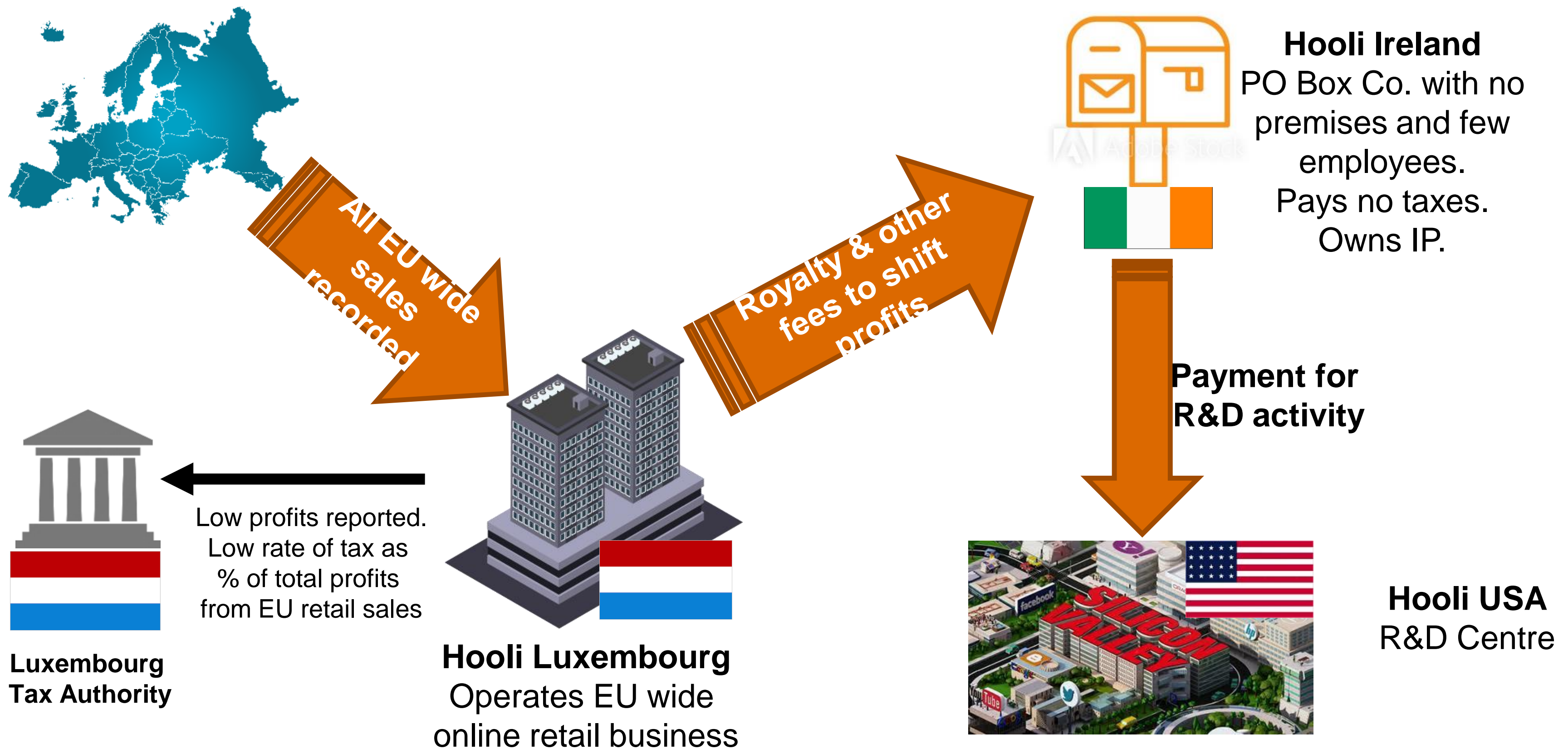
- **Multinational Pharmaceutical Group**
- **Parent holding company A BV in the Netherlands which owns ten subsidiaries including company X SA in Switzerland and Y SAS in France**
- **Parent company did not employ any full time employees in 2006/2007 and employed average of three employees in 2010/2011**
- **French company carried out all research activities on behalf of parent company and remunerated at cost plus 15%**
- **Results of all research activities became property of parent company and French company informed of the progress of the transactions directly to parent or through Swiss company**

- By an agreement, the parent company granted the Swiss company access to the research and development activities carried out on payment of royalty @2.5% of all revenues generated on sale of products
- Swiss Tax Administration initiated tax assessment and tax evasion attempt procedure for years 2003 to 2010 in the year 2013 against Swiss company and claimed that royalty charge not justified by commercial use
- Parent company had no substance or technical expertise to carry research activity and in practice the R&D activity of the Group was led by the Swiss company which subcontracted some of the activities to French company. Patents were registered in Swiss company name.

-
- Swiss Tax Administration considered royalties paid less costs paid to French company as unjustified expenses on a commercial basis
- Swiss company claimed that parent company assumes financial, regulatory, and operational risks and it should be compensated for the same
- The Federal Court concluded that parent company was a mere shell company and was not involved in the group R&D activities and had no/very few employees.
- Federal Court noted Swiss company had 60 employees and made all strategic decisions over R&D functions and parent did not had the required substance to be entitled to royalty payments.
- The Court disregarded the transaction and payment was held to be hidden distribution of profit leading to tax evasion.

Case Study 4- E-Tailer

BUSINESS MODEL – ONLINE RETAILER "E-TAILER"



VALUE DRIVERS FOR E-TAILERS

	Technology Development	Inbound Logistics	Manufacturing/ Operations	Outbound Logistics	Marketing/ Sales	Service
Functions in General	R&D Production engineering Product and process design etc	Quality control Receiving Storing goods in warehouses etc.	24 hours Payment system Production Maintenance Control etc.	Dispatch Delivery Invoicing	Marketing	Administration of returns/ warranties
Value 1. Individualized Production	Software for analysing Data demands to create personalised valuable offer	-	-	Standard shipping/ Prime delivery	Personal discounts Vouchers Analysing personal demand and making offers	-
Value 2. Complementarities	Software for analysing Data on purchases	-	Integration of many sellers Variety of production	-	Analysis of demand for complementeries	-
Value 3. Lock-in	One-click payments Personal cabinet Data storing	-	Production of own goods and quality control	-	Discounts Recommendations	Administration of returns/ warranties
Value 4. End to End Digital Integration	Development and update of the platform	-	-	-	24-hours access Social networks Cooperation	-
Main Function undertaken by	**Hooli USA**	**Hooli Lux.**	**Hooli USA**	**Hooli Lux.**	**Hooli USA** **Hooli Lux.**	**Hooli Lux.**

ISSUES

Cross border digital sales by no/low-tax domicile entity with no presence in high(er) tax market jurisdiction

- ✓ How should profits be attributed in such a case?
- ✓ Weightage: Market v/s IP
- ✓ BEPS through Royalty – how to tackle
- ✓ R&D function – risk & reward
- ✓ Applicability of Profit Split Method – appropriateness & challenges, DAEMPE analysis, determining sources of & contributors to value creation

- Glencore transfer pricing case 2019
- Mining industry marketing hubs

Glencore case: Facts

- CSA mine acquired by Glencore in 1998 and operated by CPML
- Glencore International AG (Swiss parent) (GIAG) purchased all the copper concentrate produced at the mine
- Up until 2007 the contracts were market-related agreements

- In 2007 a price sharing agreement was used
- Copper priced using as a reference the London Metal Exchange cash settlement price for “grade A” copper over the quotational period
- A deduction was made for treatment charge called the treatment and copper refining charge (TCRC)

- The charge was 23% of the copper reference charge for TCRC
- The cost-sharing was used for 2007, 2008 and 2009

Commissioner’s adjustment

- The amended assessment (para 4)
  - Adjustments to the remove the 23% TCRC
  - Replace it with a 50% benchmark and 50% spot TCRC
  - Adjustment to reflect the “consistently applied quotational period”

Commissioner’s contention

- Commissioner claimed that an independent party would not have agreed to the sharing agreement

The task

- Under Div 13 the task to substitute the arm’s length price for the supply of property
- Under Subdiv 815-A the task is to substitute the arm’s length profit for the non-arm’s length profit (para 309)

Comparables

- The taxpayer produced comparable transactions (para 249)
  - The contracts were agreed in the copper concentrate market in the period leading up to 2007
  - Reflect the pricing structure of independent parties

Comparable contracts

- The provisions of the 2007 agreement were observable in contracts between GIAG and independent enterprise (para 312)
- The counter-parts were acting in a commercially rational manner

- Davies J accepted the taxpayer’s argument (para 314)
- The OECD Guidelines and Chevron make it clear that the task is that the hypothetical should be based on the form of the actual contract on the assumption that they are dealing at arm’s length

- The case does not fall within the two (reconstruction) exceptions in the OECD Guidelines (para 319)
- The 2007 Agreement was a form of agreement seen in the market between independent parties
- The price sharing methodology was a legitimate and accepted way for copper concentrate to be priced (para 320)

Glencore: Conclusion

- The taxpayer established that the prices it was paid by GIAG were within the arm's length range (paras 382-5)

Mining Industry Marketing hubs

- Marketing hubs typically provide marketing and sales functions for goods or commodities that are produced in Australia and sold offshore
- Australian mining companies are using marketing hubs in Singapore to sell minerals and ores

- The Australian Taxation Office (ATO) claimed that excessive profits were being shifted to Singapore through marketing hubs
- In 2017 the ATO issued a risk assessment for marketing hubs

- In 2018 the ATO reached a settlement with BHP on its transfer pricing adjustments
- BHP announced that the adjustment was AUD 0.5 billion
- The ATO announced that BHP will return all its profits from its Singaporean marketing hub to Australia
  - Green zone for risk rating

Thank You!