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Intercompany Services Transactions: The Newest Dispute Engine

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Topics

- **New USA Temporary Service Regulations compared to the OECD**
- **IP and the appropriate compensation for services: birth of the “super mark-up”**
- **Other areas of controversy surrounding intercompany service charges**
- **Asia and India: the Labor Savings conundrum**

Key features/ changes – IRS Temporary Service Regs.

Introduction of New pricing method - Services Cost Method (SCM)

- **new version of “Cost Safe Harbor”**
- **covered/ specified services; low margin services**

Guidance on shared services arrangements

- **concept similar to OECD Guidelines on CCA**
- **allocate costs based on each participants share in anticipated benefits**

Inclusion of equity-based compensation (eg. options) in service cost

Narrower definition of Stewardship vs. previous Regs.

New US Regulations – Key features/ changes – Intangibles

High value services vs.. transactions involving “non-routine contributions” (?)

E.g. contributions of local operations to marketing intangibles?)

Profit Split Method applicable in case of “non-routine contributions” by both parties

Contractual arrangements

- **Legal vs. economic ownership**
- **Economic substance in case IP development is bundled/ embedded with other transactions**

Robust upfront documentation covering legal and economic realities – utmost necessity

IRS may impute contractual relationships based on economic substance if you do not (or even if you do)

Issue for consideration

Stewardship defined very narrowly by the IRS

Stock-based compensation – how will this be viewed by non-US tax authorities

- Consider “clawback” language related to stock-based compensation in service agreement**

Practical issues and real life experience

-- Treatment of high value services & embedded intangibles

US – GSK

IRS posits that GSK's US affiliate has created marketing intangibles associated with US marketing activities (high value service)

- Incremental marketing activities lead to practical control of product brand
 - Detailing force
 - Product launch costs
 - Branding activities
- Contract did not provide for “separate remuneration” of product launch and branding (vs. implicit remuneration via CPM/TNMM type method)
- IRS adjustment asserts a “super mark-up”

IRS is applying similar concepts in other cases today as are other countries

Issues for consideration - Takeaways

Treatment of high value services and embedded intangibles

Key Takeaways

Critical matters

- **Application of IRS' positions on "high-value" services and "non-routine contribution" for outbound (US) and inbound (non-US) cases by both taxpayers and non-US Tax Authorities**
 - **Issues of locally developed intangibles have been around for many years. Expect a backlash in due time on US MNCs' operating in foreign jurisdictions**
- **Definition of economic substance is very broad – can mean anything**
 - **Agreements are still determinative so long as the economic substance is consistent with arrangement and the marketplace generally**
 - **On high-value services (e.g., marketing or R&D) consider separate agreement for contracted activities**

Practical issues and real life experience in Asia/Pacific

Treatment of high value services and embedded intangibles – Bringing it all together

APAC

Tax authorities in Asia are formulating opinions on the new US regulations. Views will also take time to trickle down from CA/APA negotiations to the field level. Need to monitor reaction over time.

While countries in the region are quite diverse, some general perspectives are...

- **Legal ownership subject to consistency with economic ownership – substance over form**
 - **Contractual terms still respected, but actual conduct of the parties is key**
- **Tax authorities have argued that local operations have developed local intangibles – new US Regs. could support this point of view resulting in the need for higher mark-ups or application of profit splits or other contingent claims to profits by the subsidiaries.**
- **Deductibility of management service fees and other inbound service charges continues to be a major issue in many jurisdictions.**
 - **Focus is on the cost base as well as the mark-ups.**

Practical issues and real life experience in India: Some relevant issues

Contribution of Indian Company regarding locally developed intangibles

- do efforts/ costs lead to increase in value of IP owned by overseas group company and if so were these services performed on a “contract basis”
- or
- merely enhance value of rights/IP of the Indian Company

“Non routine contributions”/ IP creating services undertaken by Indian companies

- tax authorities proposing application of PSM
- expect high mark-ups
- Possible other contingent claims or royalties?

Location savings – seek high profit ‘mark-ups’ for services activities due to lower relative costs

-sustainable in a competitive environment?

Indian TP – Some relevant issues

Business restructuring from full service to limited service

Deemed disposition of intangibles – migration from full risk to stripped risk

- **Is there transfer of protected or unprotected IP?**
- **Is there loss or migration of profit potential?**

Valuation of intangibles – exit charges for deemed IP migrations?

Outbound companies: Indian MNCs with US operations – need to be careful about new US TP Rules

Q&A – Discussions

Thank you

