Wolters Kluwer

GLOBAL TAX WEEKLY
a closer look

ISSUE 181 | APRIL 28, 2016

SUBJECTS TRANSFER PRICING INTELLECTUAL PROPERTY VAT, GST AND SALES TAX CORPORATE TAXATION INDIVIDUAL TAXATION REAL ESTATE AND PROPERTY TAXES INTERNATIONAL FISCAL GOVERNANCE BUDGETS COMPLIANCE OFFSHORE

SECTORS MANUFACTURING RETAIL/WHOLESALE INSURANCE BANKS/FINANCIAL INSTITUTIONS RESTAURANTS/FOOD SERVICE CONSTRUCTION AEROSPACE ENERGY AUTOMOTIVE MINING AND MINERALS ENTERTAINMENT AND MEDIA OIL AND GAS

COUNTRIES AND REGIONS EUROPE AUSTRIA BELGIUM BULGARIA CYPRUS CZECH REPUBLIC DENMARK ESTONIA FINLAND FRANCE GERMANY GREECE HUNGARY IRELAND ITALY LATVIA LITHUANIA LUXEMBOURG MALTA NETHERLANDS POLAND PORTUGAL ROMANIA SLOVAKIA SLOVENIA SPAIN SWEDEN SWITZERLAND UNITED KINGDOM EMERGING MARKETS ARGENTINA BRAZIL CHILE CHINA INDIA ISRAEL MEXICO RUSSIA SOUTH AFRICA SOUTH KOREA TAIWAN VIETNAM CENTRAL AND EASTERN EUROPE ARMENIA AZERBAIJAN BOSNIA CROATIA FAROE ISLANDS GEORGIA KAZAKHSTAN MONTENEGRO NORWAY SERBIA TURKEY UKRAINE UZBEKISTAN ASIA-PAC AUSTRALIA BANGLADESH BRUNEI HONG KONG INDONESIA JAPAN MALAYSIA NEW ZEALAND PAKISTAN PHILIPPINES SINGAPORE THAILAND AMERICAS BOLIVIA CANADA COLOMBIA COSTA RICA ECUADOR EL SALVADOR GUATEMALA PANAMA PERU PUERTO RICO URUGUAY UNITED STATES VENEZUELA MIDDLE EAST ALGERIA BAHRAIN BOTSWANA DUBAI EGYPT ETHIOPIA EQUATORIAL GUINEA IRAQ KUWAIT MOROCCO NIGERIA OMAN QATAR SAUDI ARABIA TUNISIA LOW-TAX JURISDICTIONS ANDORRA ARUBA BAHAMAS BARBADOS BELIZE BERMUDA BRITISH VIRGIN ISLANDS CAYMAN ISLANDS COOK ISLANDS CURACAO GIBRALTAR GUERNSEY ISLE OF MAN JERSEY LABUAN LIECHTENSTEIN MAURITIUS MONACO TURKS AND CAICOS ISLANDS VANUATU

ISSUE 181 | APRIL 28, 2016

BEPS Action Items: In Depth

by Jeanne P. Goulet and Angela Sadang, Marks Paneth LLP, independent member of Morison International

Taxation And Technology: Playing Catch-Up In A Digital World

Contributed by Jeanne P. Goulet, Marks Paneth LLP, independent member of Morison KSi

The OECD has recently expressed growing concern about tax planning by multinational enterprises (MNEs) that makes use of gaps in the interaction of different tax systems to artificially reduce taxable income or shift profits to low-tax jurisdictions in which little or no economic activity is performed.[1]

Due to the rapid development of the digital economy, many countries are worried that they are losing tax revenue. And this is by no means an unfounded fear: technology has rapidly outpaced tax legislation and governments worldwide are trying to catch up.

Shifting Taxing Rights To Source/Market Countries

With this in mind, the OECD issued its Addressing the Tax Challenges of the Digital Economy, Action 1 – Final Report in 2015. Its aim was to minimize aggressive tax planning and to encourage governments to diminish gaps and tax arbitrage opportunities in their domestic laws. However, while the aim was simple, accomplishing it adds extra layers of complexity.

The report recommended a modification of "taxing rights" among nations, shifting "taxing rights" from resident countries to source/market countries. In this way governments in the source/market country would be allowed to unilaterally tax economic activities within their borders – but only in the case of clear-cut treaty abuse (see "Action 1 Recommendations", below, for details). Of course, this may lead to double taxation if not accompanied by a foreign tax credit mechanism.

In developing their recommendations, the OECD wisely suggested that the digital economy not be "ringfenced," as it is quickly becoming a fundamental part of the global economy. They are taking a "wait and see" approach in order to gather additional data and study other taxation options before taking on the broader challenges of the digital economy.

Indirect Tax

The effect of shifting taxing rights for direct tax purposes is clear enough, but what happens with regard to the source/market country when considering the effect of the indirect tax system? In this instance, the OECD recommends the implementation of Guidelines 2 and 4 of their International VAT/GST Guidelines. While the direct income tax system is shifting toward source base, the indirect tax system is also source based for both Guidelines 2 and 4. Thus, Guideline 2 would allocate taxing rights on the cross-border supply of services and intangibles to the location of the business owner's establishment. Guideline 4 indicates that taxation accrues to the location where the customer actually uses the service or the intangibles. Both look to the source/market country or place of use.

To further complicate the creation of global standards for tax collection, the US indirect (sales/use) tax system is at the subnational level and is not part of the OECD treaty process. Thus it is excluded from the international discussions on VAT/GST.

Gathering Data From 10 Percent Of Corporate Taxpayers And Assessing Outcomes

Over the next few years, the OECD and various countries will be gathering data collected from the VAT/GST system, as well as from country-by-country (CbC) reporting. In this way, they will be able to assess the results generated by the BEPS report and determine if more radical measures, or alternative tax concepts, are necessary.

It's worth noting that only MNEs with annual revenues of EUR750m or more are required to file the CbC report. However, many governments believe that while this reporting requirement will fall on 10 percent of the largest taxpayers, it will nevertheless encompass some 90 percent of all corporate revenues.

Although this methodology is clearly useful for some countries, it ignores the ever-growing population of micro MNEs. In fact, tax policies that target large enterprises can have unintended, often adverse, consequences for smaller players, such as additional tax complexity and the increased cost of compliance.

Action 1 Recommendations

Although Action 1 addresses the digital economy, many of the other 14 Action Plans of the BEPS report are incorporated in Action 1. The OECD hopes that these measures will address the BEPS issues exacerbated by the digital economy. The recommendations address the following issues:

Treaty abuse (Action 6): Governments observed that taxpayers might insert a shell company within a favorable treaty network but little protection against treaty abuse. The OECD recommends limitations on treaty shopping and the use of dual-resident companies. The source/market country could thus ignore the tax treaty and assert that a permanent establishment (PE) has been established, giving rise to either local taxation or to the application of withholding taxes on the transaction.

Prevent the artificial avoidance of PE status (Action 7):

- **Anti-fragmentation:** An enterprise might engage in activities in a country that are preparatory or auxiliary in nature and still not cross the "threshold." The OECD recommends that the "preparatory or auxiliary" definition be modified and that a new "anti-fragmentation rule" be included. The activities of related companies operating in a country will need to be taken together and evaluated as to whether the totality of the activity is still preparatory or auxiliary or whether, taken together, they are creating a PE in the source/market country.
- **Warehouse:** In the past, the maintenance of a warehouse in a country did not create a PE. Targeting companies such as Amazon, the OECD recommended that a large local warehouse, where a substantial workforce is in place to quickly fulfill customer orders, would no longer qualify as an exception to a PE. Such activities would be considered a core activity and would create a PE in the source/market country.
- **Signing Contracts:** A company could avoid creating a PE in a country if the local subsidiary did not sign contracts on behalf of the principal/parent company. This very formalistic approach avoided the creation of a dependent agent in the source/ market country. The OECD has recommended that if a local subsidiary that is selling goods or services in a country plays the principal role in the conclusion of contracts, and if these contracts are routinely or automatically signed by the parent without making material modifications, then the local subsidiary would be considered to be a dependent agent of the parent company. A dependent agent would create a PE for the parent company and would draw the parent into the tax net of the market country.

These modifications serve to lower the threshold for establishing a PE in a source/market country. These provisions will add uncertainty and complexity in managing cross-border operations by removing "bright line" tests. Now an added layer of judgment is required to analyze whether an activity is a "core activity" or yet whether a subsidiary is playing a "principal role" *versus* a "supporting role" in the conclusions of contracts.

In some countries, such as the United States, onerous consequences may apply to a non-US company if it has an unintended PE in the US and does not file a tax return. Tax may be imposed on revenue, and deductions might not be allowed! For a micro MNE with overall losses, such a ruling could destroy the business.

In future work on the digital economy, it would therefore be useful if "safe harbors" were developed, which would eliminate unexpected or "pop-up" PEs. For example, if a company sets up a subsidiary in a local jurisdiction, transfer pricing mechanisms could be used to reallocate income, rather than drawing an offshore related company into the local tax net as an unexpected PE.

Measures that will address BEPS issues in both market and ultimate parent jurisdictions (Actions 2, 4, 5, 8–10): MNEs reduce taxation by moving income-producing functions to low-tax jurisdictions. Governments allege that intangibles with artificially low valuation can be transferred to a country with a lower tax rate. After the transfer, a large return on investment is claimed in order to pay tax at a substantially lower rate of tax.

The OECD recommends the following Actions to minimize these abuses:

> **Action 2** – neutralizing the effects of hybrid structures by recommending that countries modify their domestic rules and change the OECD model treaty.
>
> **Action 4** – limiting base erosion *via* excessive interest deductions and other financial payments by recommending best practices for countries to incorporate into their domestic legislation.
>
> **Action 5** – countering harmful tax practices employed by some countries that have set up preferential IP regimes, which allow payment for R&D but no core activities are actually taking place in the country.

Actions 8–10 – assuring that transfer pricing outcomes are in line with value creation, *i.e.*, income should be allocated to the location that gives rise to that income. The areas of focus include:

- Transfer and use of intangibles, including hard to-value intangibles and cost contribution arrangements;
- Delineating the actual transaction and business risks;
- Global value chains and transactional profit split methods.

In the past, an enterprise could develop intangibles in one country but have them legally owned and funded by another company in a low-tax jurisdiction. The largest return on investment would go to the legal owner/investor who funded the activity and assumed risks, even if no R&D occurred in that jurisdiction.

The OECD recommended that in order to be entitled to a higher return, the enterprise can no longer be merely a legal owner or an investor. Premium returns would only be available if the enterprise also participated in the DEMPE (development, enhancement, maintenance, protection and exploitation) functions in addition to the legal ownership and funding aspects. Legal ownership alone does not entitle the owner to premium profits.

Future Work

Time will tell how technology will develop in future, but it seems clear that the lack of consensus among governments and the absence of guidelines for revenue characterization from the digital economy will have a detrimental effect on global business. The current state of affairs may well result in increased compliance costs, to say nothing of the debates and disputes that will invariably arise because of double taxation issues. Taken together, all of these factors could have unintended – and unwelcome – consequences for governments worldwide, as well as for taxpayers.

Taxing Intangible Assets: A New Global Approach

Contributed by Angela Sadang, Marks Paneth LLP, independent member of Morison KSi

In recent years the OECD has been trying to tighten controls and ensure that member countries do not assign low values to intangible assets for the purpose of transferring them from one tax jurisdiction to another with more favorable tax rules. The OECD has become particularly concerned over procedures that artificially segregate taxable income from the activities that actually generate and create value.

The OECD's main objective is to "assure that transfer pricing outcomes are in line with value creation." Its goals, as detailed in the Action Plan, are:

- Adopting a broad and clearly delineated definition of intangibles;
- Ensuring that profits associated with the transfer and use of intangibles are allocated in accordance with (rather than divorced from) value creation;
- Developing transfer pricing rules or special measures for transfers of hard-to-value intangibles;
- Updating the guidance on cost contribution arrangements and adopting transfer pricing rules or special measures to ensure that inappropriate returns will not accrue to an entity solely because it contractually assumed risks or provided capital.

With that in mind, in October 2015 the OECD issued its final report on all the 15 Action Plans. Its aim was to restore confidence in the international tax framework by addressing weaknesses that create opportunities for base erosion and profit shifting (BEPS). The focal point of the report's Chapter VI is ensuring that the profits associated with the transfer and use of intangibles are appropriately allocated in accordance with value creation.

Identifying Intangibles

The OECD defines "intangible" as something that is not a physical/financial asset, that can be owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties. The OECD recognizes the following as intangibles:

- Know-how and trade secrets;
- Trademarks, trade names and brands;
- Rights under contracts and government licenses;
- Licenses and similar limited rights in intangibles;
- Goodwill and ongoing concern value.

It is worth noting that group synergies and market-specific characteristics are not recognized as intangibles, since they cannot be controlled by any party or group. The OECD also emphasizes that an intangible for accounting or tax purposes may not necessarily be considered as an intangible for transfer pricing purposes.

Ownership Of Intangibles And The DEMPE Of Intangibles

Determining (a) the owner of an intangible and (b) the contributors – that is, the parties responsible for the development, enhancement, maintenance, protection and exploitation (DEMPE) of that intangible – is important in identifying the proper allocation of profits and costs for transactions that comply with the "arm's length" principle.

Although legal rights and contractual arrangements form the starting-point for any transfer pricing analysis of transactions involving intangibles, as far as the OECD is concerned the pure legal owner of an intangible is not necessarily entitled to a substantial share of the returns if their role is merely that of owner. Those who assume the risks regarding the DEMPE of the intangible should be compensated for those contributions – even if they do not actually own the intangible or expect to earn a significant portion of the returns commensurate with the function and risks they have undertaken. The functions performed, assets used and risks borne by the different parties associated with intangibles should always be taken into consideration. Consequently, if the pure legal owner does not perform any key functions related to the intangible, then they are not entitled to any return derived from the exploitation of that intangible – other than "arm's length" compensation, if any.

The following are regarded as important functions that contribute to the value of the intangibles:

- Design and control of research and marketing programs;
- Direction of and establishing priorities for creative undertakings, including determining the course of "blue sky" research;
- Control over strategic decisions regarding intangible development programs;
- Management and control of budgets;
- Defense and protection of intangibles;
- Ongoing quality control over functions performed by independent or associated enterprises.

Identifying Transactions Involving Intangibles

Besides identifying the intangibles that make up a particular transaction and identifying the owner of and contributors to those intangibles, it is also important at the onset of any transfer pricing analysis to identify and accurately describe the controlled transactions that involve those intangibles. The OECD's guidelines identify two general types of transaction:

- Those involving the transfer of intangibles or the transfer of all or limited rights relating to the intangibles;

- Those involving the use of intangibles in connection with sales of goods or the performance of services where said intangibles are used, but no transfer of the intangibles themselves or rights to the intangibles takes place.

The OECD Guidelines also discuss features of an intangible that should be taken into consideration while conducting a comparability analysis, such as the exclusivity and duration of legal protection, geographic scope, useful life, stage of development and rights to enhancements; revisions and updates; and expectations of future benefits.

Functional and risk analysis provides the factual basis for establishing a transfer pricing methodology consistent with the arm's length standard set forth in Section 482 of the US Treasury Regulations and the OECD Guidelines. It is a means of organizing facts about the companies involved in specific transactions with regard to the functions performed, risks assumed and the intangible assets used in order to identify how these responsibilities are divided among the companies involved. Functional and risk analysis is crucial to the development of transfer pricing policy because:

- The economic return generated by the functions undertaken by each related party typically correlates with the risks borne and the intangible assets owned or developed;
- The functions, risks and intangible assets associated with a related party's operations usually have a significant effect on its profitability;
- The functional analysis provides the information and insight necessary to (a) determine which transaction (or entity) to evaluate, (b) establish the best (or most appropriate) method of evaluating the transaction (or entity), and (c) develop comparability characteristics to help identify comparable, independent transactions (or companies) so as to determine the appropriate arm's length pricing level of the controlled transactions.

By providing a description of the functions, risks and assets (both tangible and intangible), and their location within a corporate group, functional analysis provides the first step in evaluating the particular profit-related contributions of the various related companies, and the appropriate pricing of intercompany transactions.

Transfer Pricing Methods

Depending on the circumstances, at least one of the five OECD transfer pricing methods would be appropriate when transferring intangibles, or rights in intangibles. However, according to the

Guidelines, the comparable uncontrolled price (CUP) and transactional profit split methods are likely to prove especially useful in case of transfer of intangibles or rights in intangibles. Valuation techniques can also be useful.

The OECD recognizes that database comparables involving intangibles may be difficult or in some cases impossible to assess. In such cases, they suggest that the profit split method and/or valuation techniques might be the best method to set the arm's length prices for the transactions involving intangibles. The application of the transactional profit split method should be in line with a comprehensive analysis that considers the functions performed, risks assumed, and assets used by each of the parties in the MNE.

The use of other approaches – such as valuation techniques based on the calculation of the discounted value of projected future income streams or cash flows derived from the exploitation of the intangible – should consider such things as the accuracy of financial projections, assumptions regarding growth rates, discount rates, the useful life of intangibles and terminal values, assumptions regarding taxes, and the form of payment.

Hard To Value Intangibles (HTVIs)

HTVIs are those intangibles for which no comparables exist and profit projections are highly uncertain at the time of the transfer. However, the updated report does allow tax authorities to consider *ex post* evidence about *ex ante* arm's length pricing arrangements. This also includes any contingent pricing arrangements made when a taxpayer is unable to show that ambiguous items were factored into the pricing methodology.

Selection Of The Best (Or Most Appropriate) Method

The selection of the best (or most appropriate) method depends on a number of factors, such as (a) the availability of complete and reliable data; (b) the degree of comparability between controlled and uncontrolled transactions (or companies); and (c) the number, magnitude and accuracy of the adjustments necessary to apply the method.

Identifying comparable transactions (or companies) requires an evaluation of the functions performed and the risks assumed, as well as contractual terms, economic conditions and the types of intangible property exchanged between the affiliated entities engaged in the intercompany transaction. Each factor should be evaluated in order to determine its potential impact on the pricing

method and, depending on the approach chosen, one factor may be more important than another in establishing comparability. The documentation of these analyses (*i.e.*, functional analysis, risk analysis, and an assessment of contractual agreements) is required to support the best (or most appropriate) pricing method.

The CUP method compares the price charged in a controlled transaction with that charged in an uncontrolled transaction. Under this method, the arm's length nature of an intercompany price is determined by reference to either (a) the price charged by a member of the group for the provision of the same or highly comparable intangible property to an unrelated party (*i.e.*, an internal CUP), or (b) the price charged by an independent company for the provision of comparable intangible property to a third party (*i.e.*, an external CUP).

Conclusion

The initial step of the intangible property analysis must apply Section 482 of the Treasury Regulations and the OECD Guidelines to the intercompany licensing in order to determine the "best" (or "most appropriate") method for assessing the royalty rates.

The importance of intellectual property management for tax planning purposes is clear. When an MNE is looking at its intellectual property portfolio, the interplay of many factors must be considered, along with guidance from the OECD and the local country tax jurisdictions where affiliates are located.

MNEs should also ensure that their transfer pricing policies reflect the guidance provided by the OECD, namely that DEMPE functions should be clearly defined and the contributions of each party evaluated in order to determine which entity within the group controls the economically significant risks. What's more, when it comes to the valuation and pricing of transactions, MNEs should carefully consider which valuation techniques they employ and whether or not the substitute methodology they are using is being applied correctly. As we said earlier, the OECD's objective is to ensure that profits arising from the transfer and use of intangibles are distributed so that they are aligned with value-creating functions and the control of risks.

ambitious and client focused. Morison KSi has 1,201 partners, 8,990 professional staff and 375 offices in 88 countries.

Endnote

1 OECD (2015), Addressing the Tax Challenges of the Digital Economy, Action 1 – Final Report, page 11, OECD/G20, Base Erosion and Profit Shifting Project, http://dx.doi.org/10.1787/9789264241046-en