



Transfer Pricing in the Post BEPS world

15 September 2017



What is transfer pricing?

Pricing of transactions between related parties for:

Tangible property

Services

Intangible property

Rents

Loans

The law of Transfer Pricing- US

Current US Law, Section 482-

- In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of Code Sec. 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.

Transfer Pricing: The Arm's Length Standard

US - Arm's Length Standard - Treas. Reg. §1.482-1(b)(1)

"A controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result)."

Transfer Pricing: US Guidance

Final Regulations,

482-1 General

- Arm's length standard
- Best method rule
- Standard of Comparability

482-2 Specific Situations (*not*)

482-3 Transfers of Tangible Property

- Comparable Uncontrolled Price
- Cost Plus
- Resale Price

482-4 Transfer of Intangible Property

482-5 Comparable Profits Method

482-6 Profit Split Method

482-7 Cost Sharing

482-9 Services

The law of Transfer Pricing- International

OECD -

The Organization for Economic Cooperation and Development—

An international forum of democratic member states working together to address the economic, social and environmental challenges of globalization.

OECD - Organization

Member Countries

Australia	Korea
Austria	Luxembourg
Belgium	Mexico
Canada	Netherlands
Czech Republic	New Zealand
Denmark	Norway
Finland	Poland
France	Portugal
Germany	Slovak Republic
Greece	Spain
Hungary	Sweden
Iceland	Switzerland
Ireland	Turkey
Italy	United Kingdom
Japan	United States

OECD – Transfer Pricing

History: dates back to late 1950s, and Fiscal Committee of the OEEC

Authority: OECD Model Tax Convention, 1st draft in 1963

Art. 9 (1) –

"[When] conditions are made or imposed between... two [related] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to *one of* the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly."

Art. 9 (2) – The re-writing of transactions . . . may give rise to economic double taxation. (the tax authorities in) State B shall (although it is by no means automatic) make an appropriate adjustment so as to relieve the double taxations.

OECD Guidelines

Transfer Pricing Principles

- Separate entity basis of taxation (each member subject to tax on its income)
- Arm's length dealings (special conditions between entities should be eliminated)
- Avoidance of double tax through mutual, consensual procedures

OECD Guidelines (cont'd)

Outline

Ch. I General Principles

Ch. II Traditional Transactional Methods

Ch. III Other Methods

Ch. IV Administrative Approaches, Dispute Resolution

Ch. V Documentation

Ch. VI Intangibles

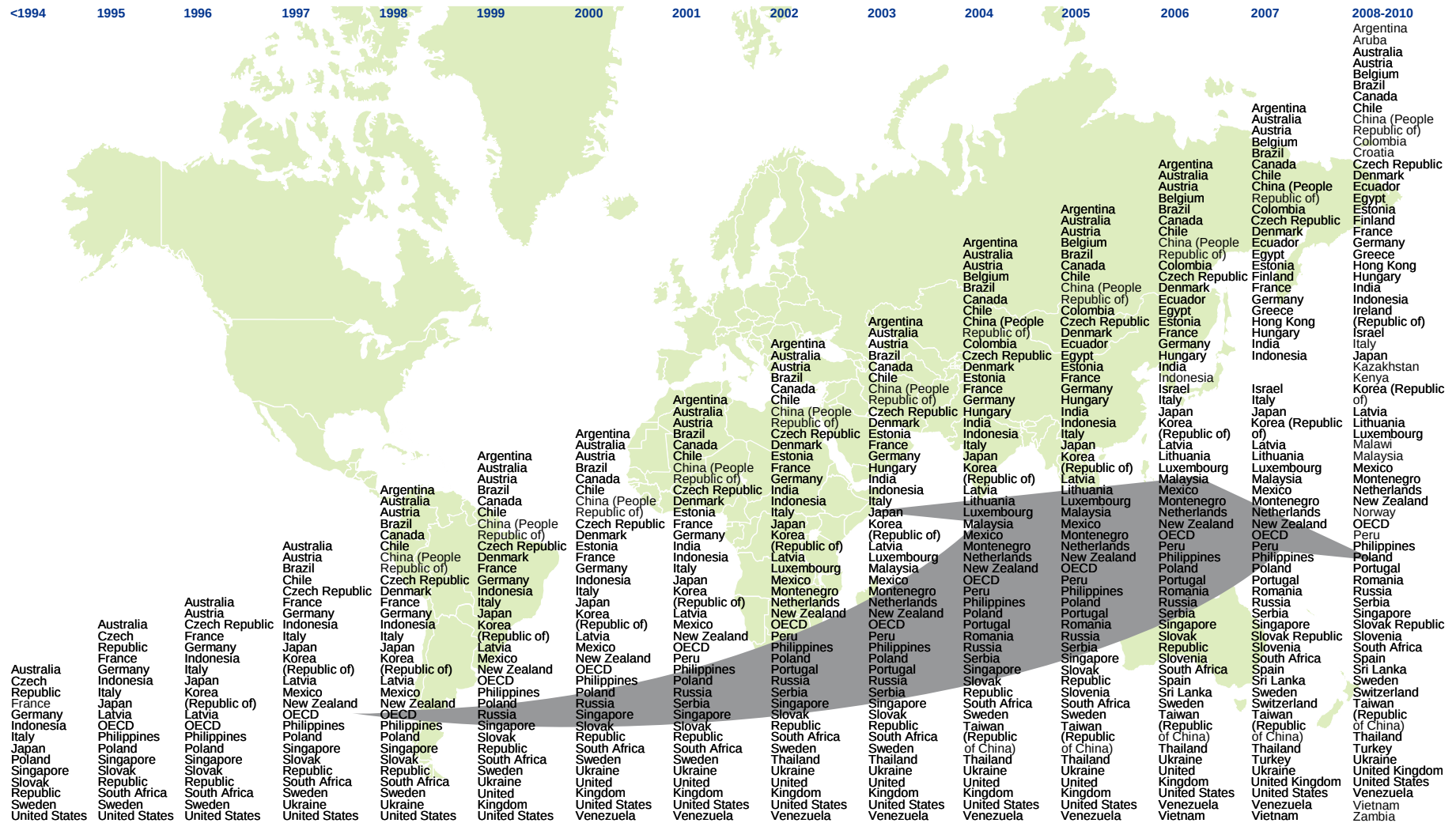
Ch. VII Intra-Group Services

Ch. VIII Cost Contribution Arrangements

Ch. IX Business Restructurings

Web site <http://www.oecd.org> and search Transfer Pricing

Global Introduction of Transfer Pricing Rules



Why is transfer pricing difficult and important?

Largely internal, embedded transactions shielded from market forces

Subjective application of the rules

Differing taxpayer-govt, and govt-govt, interpretations

Potentially large adjustments (and equally large penalties)

Often little market guidance

Double taxation exposure

Figures prominently in financial statement disclosure (ASC 740, formerly FIN 48)

Increased public exposure

OECD Base Erosion and Profit Shifting (BEPS)

Transfer pricing– profit shifting

Transfer pricing – profit shifting			
	Parent (Country A)	Sub (Country B)	Consolidated
Total profit on operational returns	700	300	1,000
Tax rate	40%	10%	
Tax liability before change to transfer price	280	30	310
Global effective tax rate (ETR)			31%
Effect of transfer pricing change on ETR			
Total profit after using transfer pricing to shift 400 of income	300	700	1,000
Tax rate	40%	10%	
Tax liability after change to transfer price	120	70	190
Global ETR			19%

Transfer pricing– profit risk

Exposure to double taxation			
	Parent (Country A)	Sub (Country B)	Consolidated
Total profit reported on tax return	300	700	1,000
Tax rate	40%	10%	
Tax liability before Country B transfer pricing adjustment	120	70	190
Global ETR			19%
Double taxation effect on ETR			
Total profit after adjustment (increase in profits) by Country A of 400 (assumes no correlative relief in B)	700	700	1,400
Tax rate	40%	10%	
Tax liability after Country A transfer pricing adjustment (penalties and interest not included)	280	70	350
Global ETR			35%

What is Transfer Pricing?

Governmental interest

Artificial shifting of income to minimize or evade tax liability, erosion of tax base

Suspension of the normal laws of supply and demand for related party transactions

Taxpayer interest

Tax minimization, maximum shareholder return

Little market guidance on related party transactions

Navigation of unclear, or contradictory government policies on cross-border transactions

Multi-lateral, NGO interest

Artificial manipulation of tax liabilities and tax rate arbitrage

Depletion of developing countries tax base, defunding of govt programs

Counter weight to development aid, delays self-sufficiency

The Public Debate on Transfer Pricing

"**Starbucks** paid just £8.6M in U.K. tax over 14 years." BBC News, October 16, 2012

"There is a technical term economists like to use for behavior like this. Unbelievable chutzpah." Edward Kleinbard, former Chief of Staff of the Congressional Joint Committee on Taxation, on **Apple's** efforts to avoid paying taxes." New York Times, May 21, 2013.

"[**Google's**] highly contrived tax arrangement has no purpose other than to enable the company to avoid U.K. corporation tax." Margaret Hodge, Chair of U.K. PAC, June 12, 2013

"From now on I'll be putting away my Kindle and feeding my caffeine addiction somewhere other than Starbucks. We know that **Amazon**, **Google** and **Starbucks** are raking in profits from their economic activity in Britain but using a range of devices to avoid paying their fair share of corporation tax." U.K. Observer, November 18, 2012

"**Apple** pays just 2% U.K. tax as **Amazon** and **Google** face questioning." International Business Times, November 5, 2012.

"**Google** caught in crossfire over French tax planning." Le Figaro, October 19, 2012

"Dolce and Gabbana to face trial over tax evasion Milan prosecutors allege the fashion had sold their **D&G** and **Dolce & Gabbana** brands to a holding company they set up in Luxembourg in 2004 in order to avoid paying high taxes in Italy." The Telegraph, June 11, 2012

"International retailers that have lowered U.K. tax by holding trademarks in the Netherlands include not only **Starbucks** and **IKEA** but also **SABMiller**, **Nike**, **Bacardi-Martini**, **Zara**, **Speedo** and **Volkswagen**. Het Financieele Dagblad, 15 November 2012

"Rampant corporate tax avoidance may not be illegal, but that doesn't make it right or fair." NY Times Editorial, May 25, 2013

"**Google** insists its Irish headquarters are more than just a 'post box.'" Le Figaro, November 6, 2012.



Base Erosion Profit Shifting Initiative

BEPS background

The changing landscape

Transfer pricing is at the heart of the debate

Governments under extreme fiscal pressure as a consequence of the global economic crisis

Increased political focus on perceived tax avoidance by multinationals

The G20 was concerned that current international tax rules and frameworks were/remain inadequate

The OECD response to growing pressure was to release the Base Erosion and Profit Shifting (BEPS) report

The G20 was applying political support/pressure to push for change

There is a drive to develop a tax system that is fit for purpose for today's multinationals and digital age

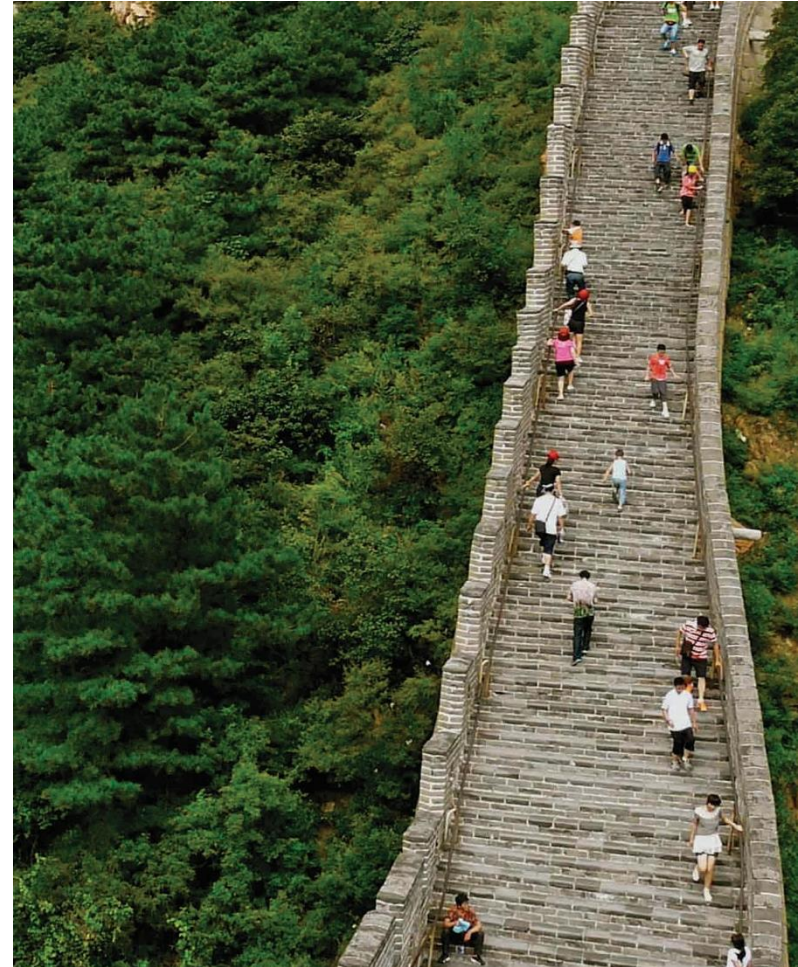
BEPS Action Plan

1. Digital economy;
2. Hybrid mismatch arrangements;
3. Strengthen CFC Rules;
4. Limit interest etc deductions;
5. Address transparency and substance;
6. Prevent treaty abuse;
7. Address PE avoidance;
- 8-10 +13. Address transfer pricing failings;
11. Analyse BEPS data;
12. Aggressive tax planning to be disclosed;
14. Increase effectiveness of dispute resolution;
15. Develop a multi-lateral instrument.



Base Erosion Profit Shifting initiative

- Intent: April 2012;
- Final Reports: October 5 2015;
- Action 8 Risk and Recharacterization;
- Action 8: Hard to Value Intangibles;
- Action 10: Role of Profit Splits;





BEPS Actions 8-10 – Interpretive issues

More Focus on People & Functions

OECD Chapter I on attribution of risk

- Contracts a starting point, conduct of parties must be consistent with contractual allocation of risk for it to be respected.
- Party(ies) assuming risk must exercise control and have financial capacity.
- Board meetings or broad policy-setting is not enough to demonstrate control.
- Contractual assignment of risk should be respected if the party assigned the risk exercises control over and has the financial capacity to assume the risk, even if other parties also exercise control.

OECD Chapter VI – intangible income and “DEMPE”

- In order to be entitled to returns from an intangible, an entity must perform “important” functions related to the intangible’s **Development, Enhancement, Maintenance, Protection, Exploitation**.
- Legal ownership alone is not sufficient for entitlement to returns from an intangible.
- Funding, without the performance of DEMPE functions, could at most expect a risk-adjusted return.

Interpretive Issues

Intangibles and DEMPE

- How does Chapter I on contracts and risk attribution apply to DEMPE analysis?
- How should income be allocated across DEMPE functions?
 - Development vs. Protection vs. Exploitation vs. Maintenance
- Increased importance of people functions
 - Which people are more valuable those that developed IP or exploit IP?
- Attribution of income to pre-existing vs. newly developed intangibles?
 - How much value does precursor contribute to the successor?

Focusing on DEMPE

Understanding Development, Enhancement, Maintenance, Protection, and Exploitation (DEMPE) Functions

- Existing “IP” models did not always include an analysis of the parties responsible for:
 - Legal ownership; and
 - Funding [economic ownership].
- Many “IP” planning strategies did not clearly define “IP”. Often it means, “anything” leading to profits above “routine” or “normal” profits. Model was applied for all industries, from high tech to consumer goods, in a similar way.
- A review of DEMPE functions may require changes to the allocation of profits in the value chain.



BEPS in Practice

Example 2-Foreign Acquisition

USCo acquired ForCo, which is organized in Germany, \$10,000. ForCo is a medical device company engaged in research, design, mfg and sale of a unique, revolutionary radiation therapy machine (“Fission Therapy”) for cancer treatment. ForCo has already sold one machine in Germany and is currently seeking EU approval to market and sell EU-wide. While the US is expected to be a leading market for the machines, to date no machines have been sold in US, nor has FDA approval been sought.

The primary facilities (research, mfg) are in Germany, while EU distb. HQ is in UK (including trademark and customer relations rights), the US currently conducts research, for FDA approval, and will later provide sales and service for the US market. USCo hired Perfect Precision Appraisal to conduct the valuation and determine the allocation of assets for financial and transfer pricing purposes.

Example 2- Foreign Goodwill (cont'd)

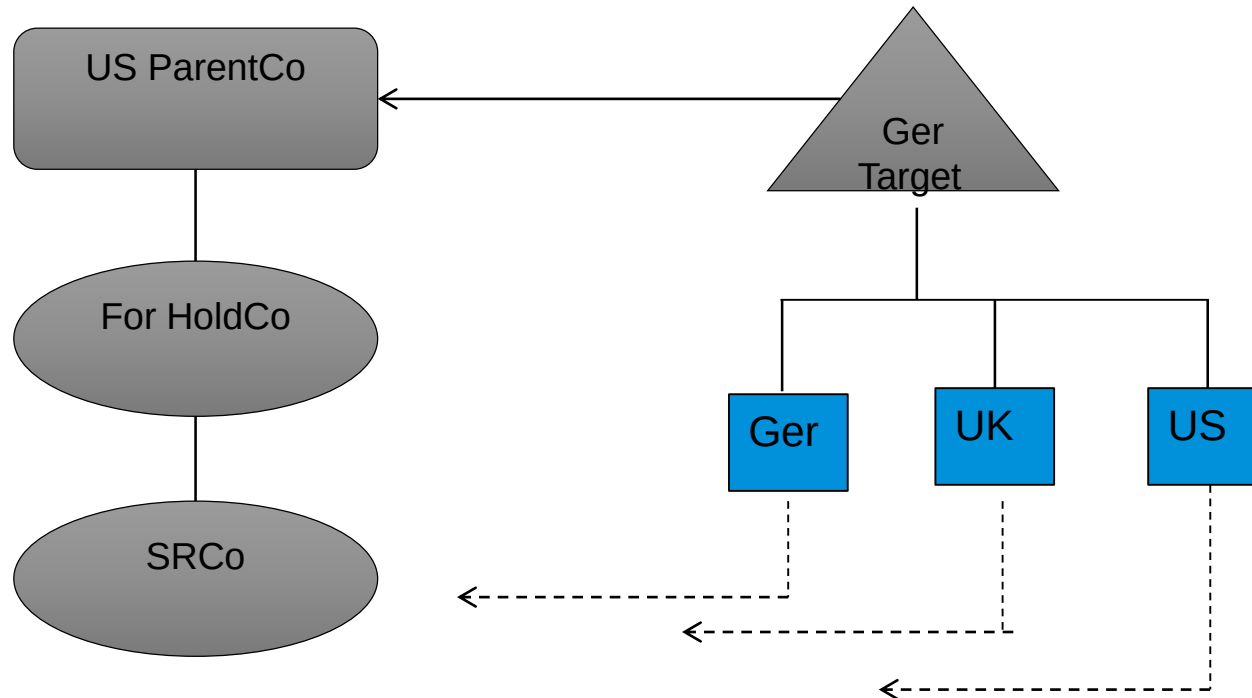
Tangible Assets	200
<u>Intangibles</u>	
Ger patents	2,000
Ger know-how	500
US know-how	100
UK trademarks	200
UK customer rel.	1,000
<i>less Purchase price</i>	<u>10,000</u>
Goodwill	6,000

Example 2- Foreign Goodwill (cont'd)

USCo currently does not provide radiation therapy, although it is a global pharma company with numerous chemical (chemo-therapy) drugs on the market. USCo will transfer FT patents to its Swiss ResearchCo (SRCo), which will be responsible for management, control, decision-making and funding of FT (and all USCo) research and regulatory approvals.

SRCo will utilize data and research developed by ForCo to further develop, complete and seek FDA approval, which is uncertain and not expected for at least 3-5 yrs.

Allocating Goodwill



Intangibles

Example 2- Foreign Goodwill (cont'd)

Given the novelty and uncertainty of the FT technology, how much, if any, goodwill should be allocated to identified intangible assets?

—*Is profit potential an asset?*

If goodwill is to be allocated, how much is US vs foreign goodwill?

Given the large, free market of US medicine, is the US entitled to a market premium?

—*Can market premium (location) be transferred?*

If US goodwill is identified, and transferred, and FT fails to win FDA approval, is US entity entitled to a refund?



Thank you

With You Today-

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