Transfer pricing in post BEPS world

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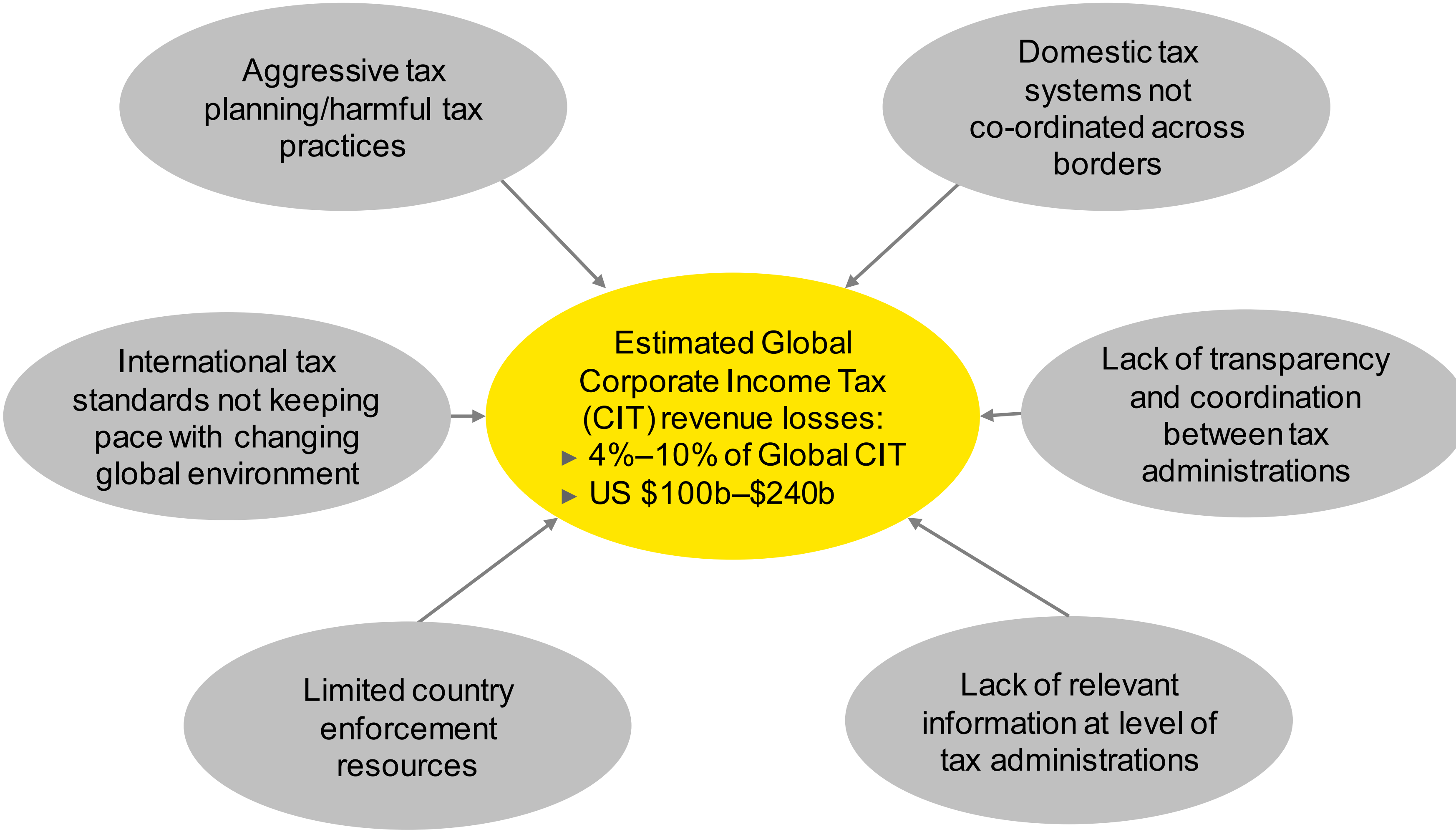
What is BEPS?

Base Erosion and Profit Shifting (BEPS) refers to tax planning strategies

- That exploit gaps and mismatches in tax rules to make profits 'disappear' for tax purposes or
- To shift profits to locations where there is little or no real activity but the taxes are low resulting in little or no overall corporate tax being paid

Reasons for BEPS



What is happening?

Changing business environment and tax challenges

Business trends

- Globalization/ regionalization
- Digitization
- Increasing complexity of value chains and infra-firm trade

New reality for global economy

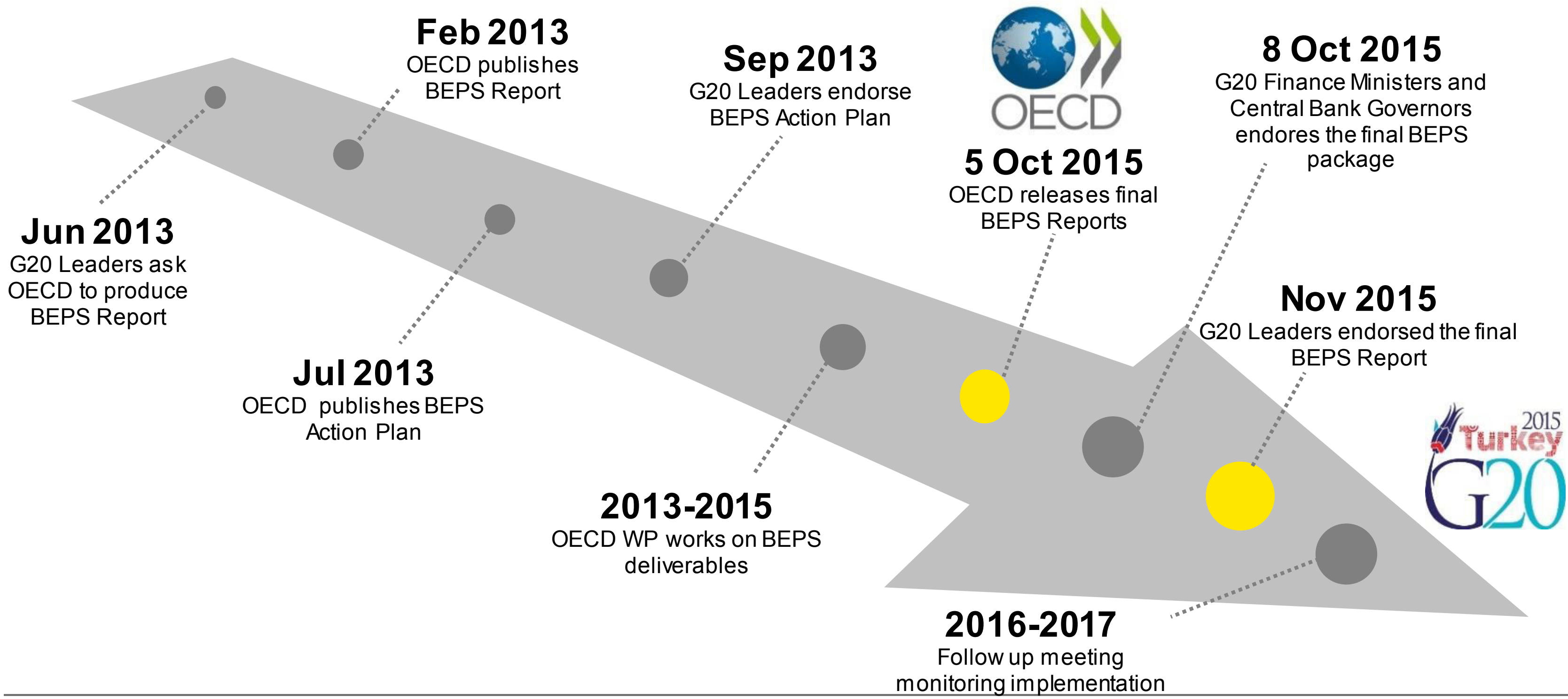
- More attention by governments, media and non-governmental organizations on the international tax profile of Multinational Companies (MNCs)
- More complexity in tax laws and information reporting obligations
- More information sharing between governments
- More robust audits and increasing controversy

Government issues

- Balancing investment stimulus and fiscal prudence following the global financial crisis
- Public outcry about the fairness of tax burdens

History of BEPS project

- On 5 October 2015, the OECD issued its 'final' reports on the 15 Action points identified in its Action Plan on BEPS. The reports have been the subject of consultation and the content of the reports is largely in line with expectations.
- This effort is supported by the G7 and G20 countries, the European Union (EU) has been working in parallel, and developing countries are involved as well.



Three pillars of OECD BEPS framework

Coherence

Harmful or inappropriate use of international tax legislation to obtain unintended tax benefits

- Hybrid mismatch arrangements (2)
- Controlled foreign company (CFC) rules (3)
- Interest deductions (4)
- Harmful tax practices (5)

Substance

Mismatches where profits are being taxed vs. where people responsible for generating these profits are located

- Preventing tax treaty abuse (6)
- Avoidance of permanent establishment status (7)
- Transfer pricing (TP): intangibles (8)
- TP: risk and capital (9)
- TP: high risk transactions (10)

Transparency

Provide tax authorities information to carry out audits better and determine if "fair share" of taxes are being paid

- Methodologies and data analysis (11)
- Disclosure rules (12)
- TP documentation (13)
- Dispute resolution (14)

Digital economy (1)

Multilateral instrument (15)

- Changes to domestic legislation needed
- Clarifies/ reinforces existing TP Guidelines
- Peer review mechanisms
- Changes to bilateral tax treaties needed

Action Plans 8 - 10 - 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
- Focus on Development, Enhancement, Maintenance, Protection and Exploitation (DEMPE) functions
- Hard-to-Value Intangibles (HTVIs)

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 split
- Recognition of transactions
- Commodity transactions

BEPS triggers a shift from **"arm's length pricing"** to **"arm's length profit allocation"**

Action Plan 8 - Identifying and defining intangibles

"Something which is capable of being owned or controlled for use in commercial activities and whose use or transfer would be compensated … between independent parties …"

Separately identifiable intangible assets

Registered IP (illustrative examples)
- Patents, designs, licences & rights
- Trademarks, names, domain names & brands
- Other contractual rights

Other intangible

Non-registered IP (illustrative examples)
- Know-how & trade secrets
- Marketing intangibles
- Distribution network & customer lists
- Product design & technology
- Process technology provided to buyers
- Supplier lists & procurement processes

Transfer pricing definition of intangibles wider than legal business or accounting definitions. For example: customer lists, supplier lists, contractual rights, proprietary market and customer data, customer relationships, negative know-how, know-who, copyright in software code

Goodwill & going concern

- Relationship Capital (innovation community, ecosystem and supply chain partnerships)
- Reputational value
- Key Human Capital

However, OECD Action 8-10 guidance explicitly excludes:
- Group synergies
- Market specific characteristics

Action Plan 8 - Six-step analytical framework for intangibles

1. Identify the intangibles and economically significant risks associated with the DEMPE of the intangibles

2. Identify the full contractual arrangements and determine legal ownership

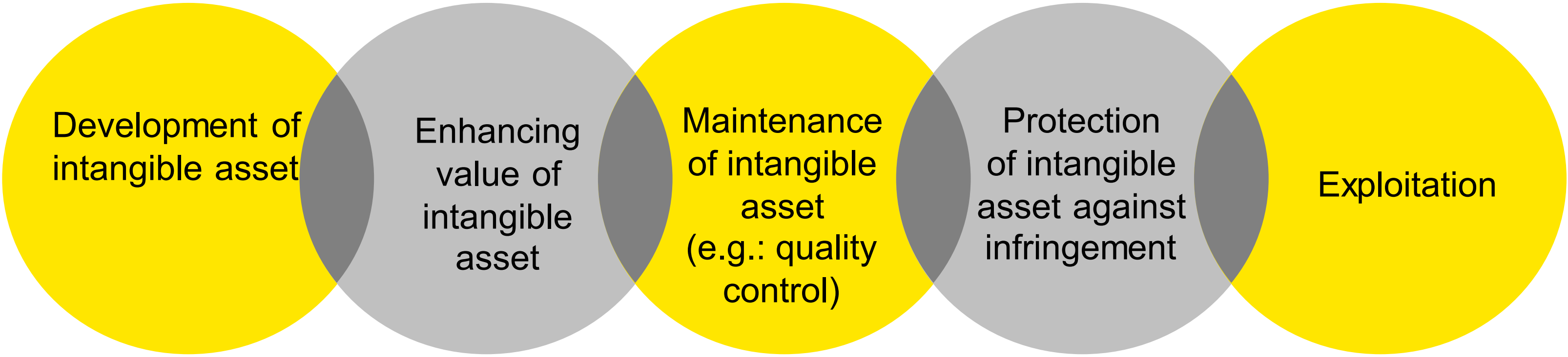
3. Detailed functional analysis to identify the parties performing functions, using assets, and managing risks related to DEMPE

4. Confirm the consistency between the terms of the relevant contractual arrangements and the conduct of the parties

5. Delineate the actual controlled transactions related to the DEMPE of intangibles

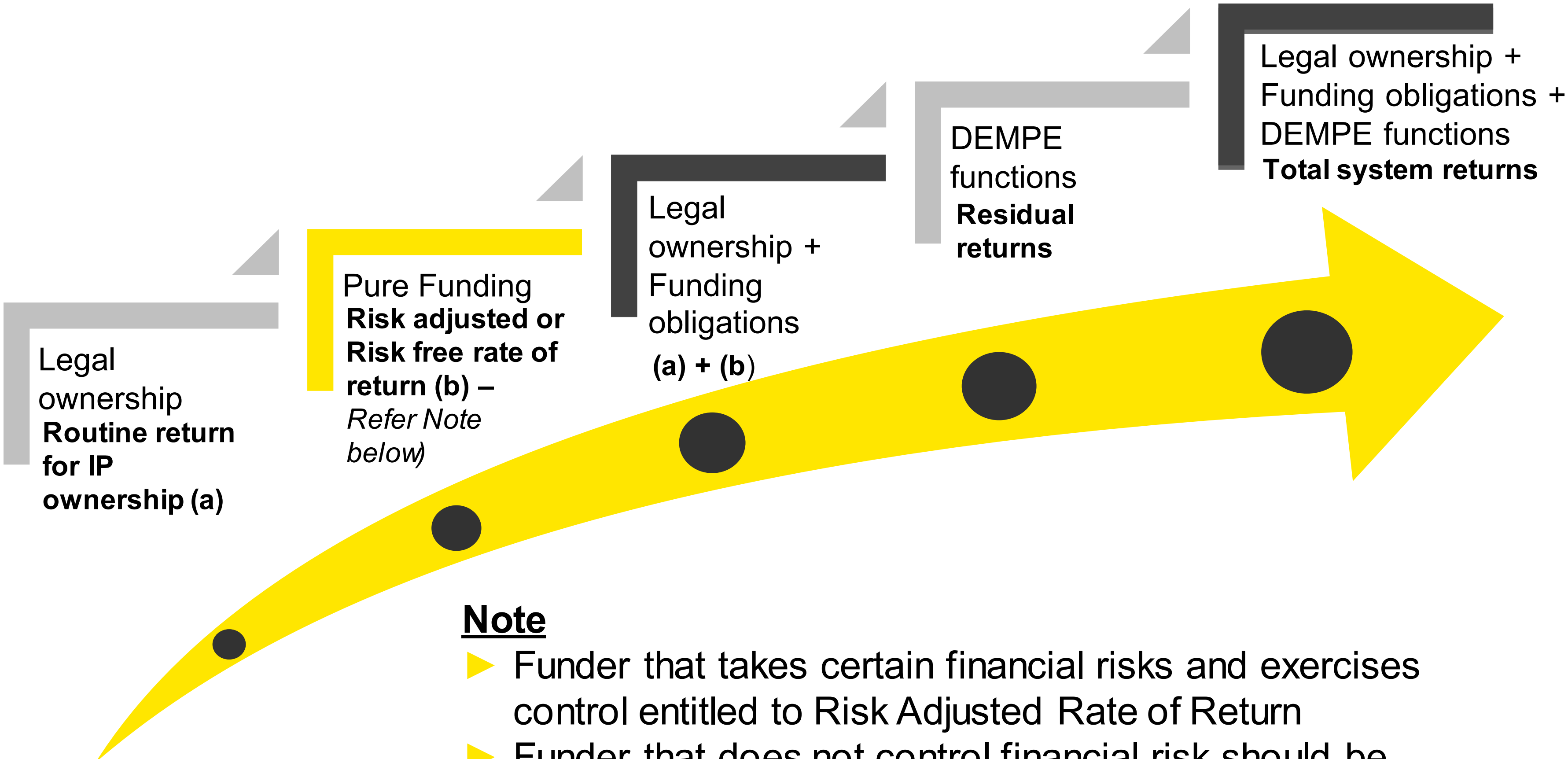
6. Where possible, determine arm's length prices for these transactions consistent with each party's contributions

Action Plan 8 – DEMPE functions



- Accurate delineation of the actual transaction is fundamental: contracts needs to be reviewed against conduct
- Return retained by an entity in group depends on the contributions it makes through DEMPE functions to the anticipated value of intangible relative to contributions made by other group members

Action Plan 8 - Return entitlement



<u>Note</u>

- Funder that takes certain financial risks and exercises control entitled to Risk Adjusted Rate of Return
- Funder that does not control financial risk should be entitled to no more than a risk-free financial return

Action Plan 8 - HTVI

- Intangibles or rights in intangibles for which, at the time of their transfer,

  i. no reliable comparables exist,

  ii. the projections or future cash flows or income, or assumptions, make it difficult to predict the level of ultimate success of the intangible at the time of the transfer

- May exhibit one or more of the following features:
  - Only partially developed at the time of the transfer
  - Not expected to be exploited commercially until several years following the transaction
  - Is integral to the development or enhancement of other HTVI intangibles
  - Is expected to be exploited in a manner that is novel at the time of the transfer
- Guidance attempts to protect tax administrations from negative effects of information asymmetry about the value of HTVIs this whilst allowing taxpayers to demonstrate pricing of HTVIs is at arm's length
- Tax administrations authorised to use ”ex post” evidence on the financial outcomes of a HTVI transaction as presumptive evidence on the appropriateness of the ex ante pricing arrangements

Action Plan 9 – TP for risks and capital

BEPS Action 9 Transfer pricing for risks and capital	
Issue	The assumption/allocation of risks can have a significant impact on the transfer prices (margins) The OECD is of the view that Profits (transfer pricing outcomes) might not in line with value creation due to a "wrong/non arm's length" contractual risk allocation
OECD Recommendations	• ***<u>Focus on conduct of the parties</u>*** in relation to the relevant risks compared to the contractual allocation of risks • ***<u>Capability and functionality to manage the risk</u>*** within the group to be used as a key indicator. Therefore, assumption of risk without 'control' over risk is likely to be problematic • If the asset owner does not have capability to control risks associated with the exploitation of the asset, the legal owner of the asset is in substance providing only financing equating to the cost of the asset, and should be remunerated on that basis • Risk transfer only if transferee is well placed or better placed to manage risk than the transferor

Action Plan 9 - Six-step analytical framework for analysing risks

1	Identify economically significant risks with specificity
2	Determine contractual risk allocation
3	Determine how the associated enterprises operate in relation to assumption and management of risks, in particular control functions and financial capacity to assume the risk
4	Interpret the outcome of step 1-3 and determine whether the contractual assumption of risk is consistent with actual conduct
5	Where the party assuming risk does not control the risk or does not have the financial capacity to assume the risk, apply specific guidance on allocating risk
6	The transaction as accurately delineated should be priced, appropriately compensating risk management functions

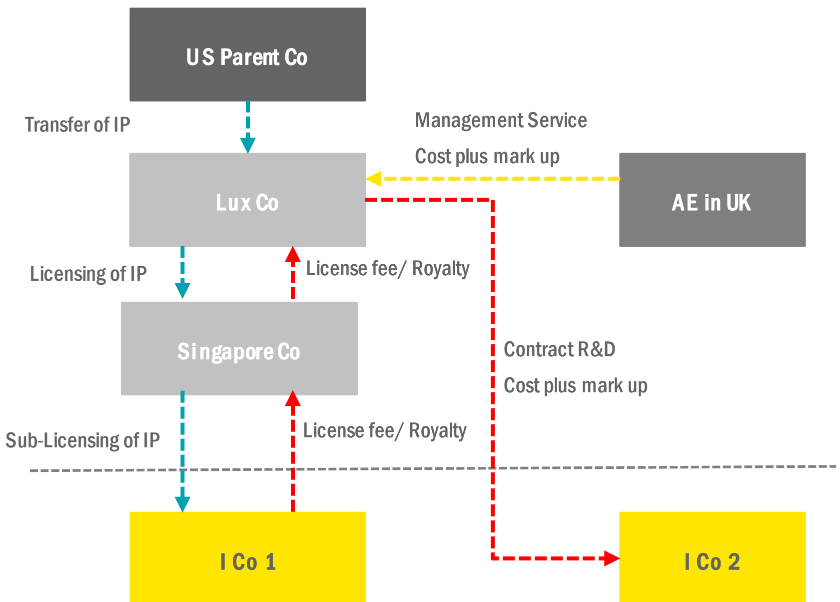
Action 10 – TP for other high-risk transactions

BEPS Action 10
Transfer pricing for other high-risk transactions

Low value adding services	Profit splits in the context of global value chains	Recognition of transactions / Re-characterization	Commodity transactions
• Aims to achieve a simplified approach • Definition • Shareholder activities and duplicative costs • Mark-ups • Appropriate cost allocation methodologies • Simplified benefit test • Documentation requirements	Scenarios where a transactional profit split method may be more appropriate than one-sided methods, e.g.: • Multisided business models • Unique and valuable contribution • Fragmentation of functions • Lack of comparables	• Title has changed to recognition instead of non-recognition of a transaction • Focus on conduct of parties over contractual terms • Emphasis on commercial or financial relations (delineating the actual transaction) • Link to notion of commercial rationality	• Protecting the tax base of commodity dependent countries • CUP considered generally as appropriate • Publicly available prices can be used as a reference • Deemed pricing date in the absence of data on the actual transaction date

BEPS: Relevance for IP structures

IP Structures
Traditional structures



- US parent company transfers IP to Lux Co
- Lux Co licenses IP to Singapore Co. Singapore Co then sub-licenses to I Co 1.
- Lux Co engages I Co 2 for contract R&D on cost plus mark-up basis.
- Lux Co engages AE in UK for management services on cost plus mark-up basis
- Lux Co is eligible for preferential IP regime.

Action 3 Designing Effective Controlled Foreign Company Rules

Action 5 Countering Harmful Tax Practices More Effectively

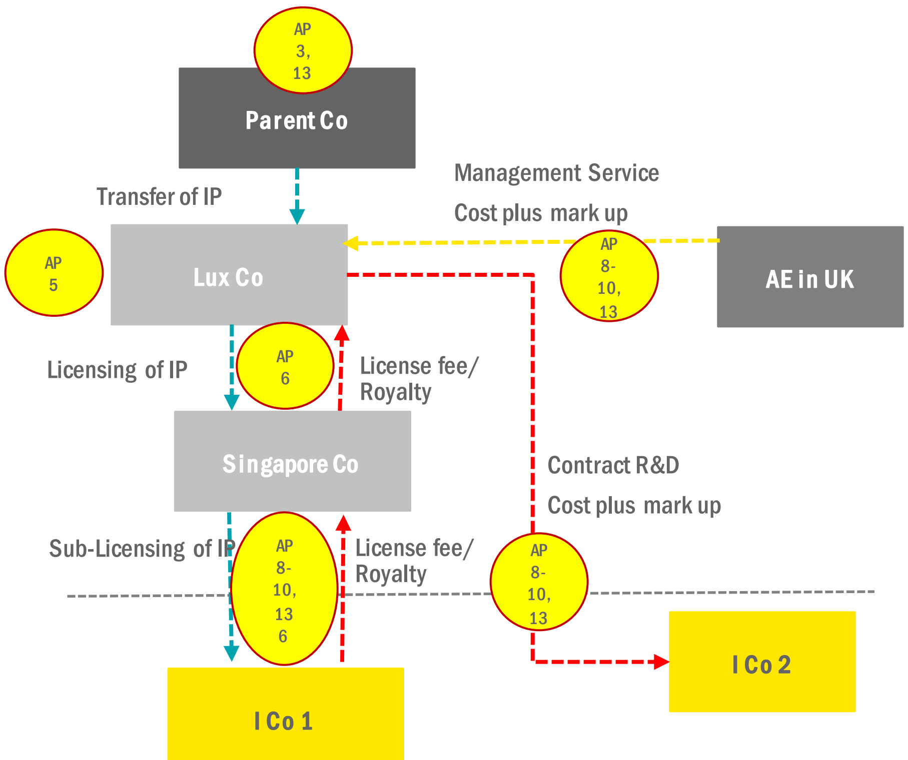
Action 8-10 Aligning Transfer Pricing Outcomes with Value Creation

Action 6 Preventing the Granting of Treaty Benefits in inappropriate Circumstances

Action 13 Transfer Pricing Documentation and Country-by-Country Reporting

IP Structures

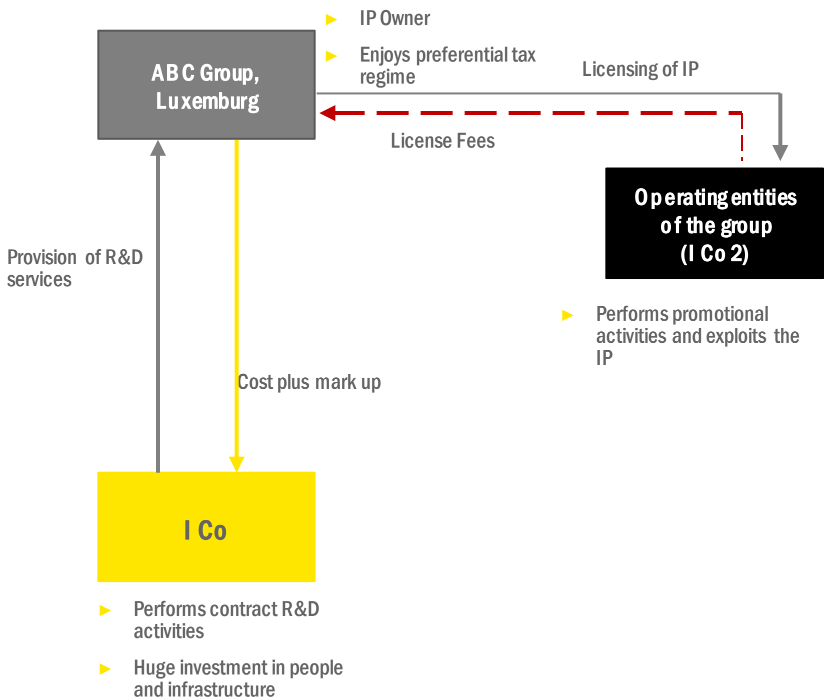
Potential implications for IP structures



- Greater scrutiny could be expected and there should be an increasingly important focus on substance
- TP documentation and CbCR could reveal key economic and tax data with respect to an MNC's IP activities and highlight low substance entities with material low tax income
- Existing intercompany TP approaches toward royalty payments, R&D activities, sales activities, manufacturing activities and other services under potential scrutiny may need to be revised
- DEMPE functions – **develop, enhance, maintain, protect, and exploit** – need to be assessed when determining if an MNC group member is entitled to any intangible related return
- Remuneration of the IP owner should be in line with its functions, assets and risk profile (e.g., funders to receive funding return; legal owners to receive return for legal administrative functions)
- Treaty shopping to achieve reduced withholding or withholding tax exemptions on royalty payments may become more difficult to achieve
- Preferential tax regimes for IP income would need to comply with the "nexus approach"

BEPS: Action 8-10 – Case Studies

Case study 1
Location of IPs and DEMPE



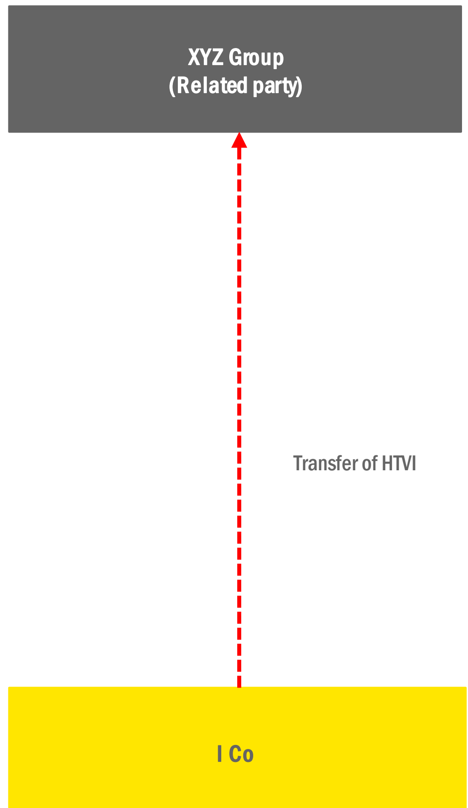
- **Facts**
  - I Co, is an India based R&D centre of ABC Group based in Luxemburg
  - ABC Group is the legal owner of group's IP located in Luxemburg where it enjoys a preferential regime for IP income (80% of IP income is entitled for "deemed deduction")
  - ABC Group outsources IP development function to I Co, and remunerates the Indian entity on a cost plus mark-up basis.
  - I Co is responsible for all the important decisions in respect of research, IP development programmes and budgets etc.
  - ABC Group licenses the IP to other operating entities of the group (including I Co2, another Indian company) and earns license fees
- **BEPS impact on the structure**
  - Availability of continued benefits under Lux IP regime
  - Appropriate allocation of IP related income having regard to DEMPE functions

Case study 1 (contd)
Key implications for ABC group

- **Pre-BEPS scenario**
  - Preferential IP regime for income earned by legal owner of IP (Lux)
  - Arm’s length principle based on contractual allocation risks resulted in R&D entity earning a routine return of cost plus
  - Arm’s length royalty rate determined using “database CUPs” or TNMM using combined approach

- **Key implications of the BEPS guidance:**
  - Restricted benefit for Lux Co under modified nexus approach may require re-think on strategy of separating IP ownership and R&D activities – would conducting R&D activity through a foreign branch be preferable?
  - Risk of “flipping the tested party” (i.e. Lux entity) while applying the TNMM or using a Profit Split Method
    - What and where are the DEMPE functions carried out – there could be multiple entities performing DEMPE functions as well as mobility with regard to the functions
    - Depending on the relevance of DEMPE and “risk managing” functions performed, ABC Group may not be entitled to more than just a risk-adjusted return on its funding activity and a cost plus fee for administrative services. In case no risk controlling functions are assumed in relation to the funding, merely a risk-free return should be due

Case study 2
Outbound transfer of newly developed IPs to an overseas holding co.



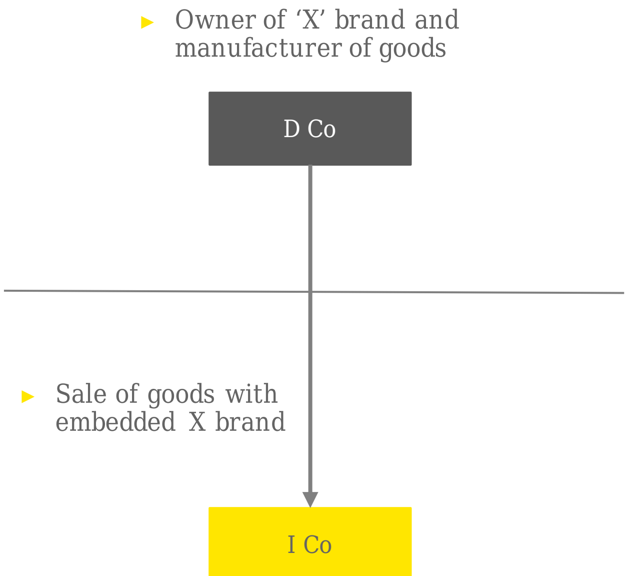
- **Facts**
  - I Co, a fully integrated e-commerce entity, functions as an online repository of medical practitioners in India
  - I Co has developed the unique IP and controls/ manages the entire gamut of activities pertaining to the DEMPE of such IP
  - As part of a group restructuring, I Co transfers the IP to an offshore holding co.
  - Since the revenue/ profit potential of the IP is not fully known at the time of transfer, I Co transfer the IP at cost incurred in its development plus a small profit element
  - XYZ thereafter engages I Co for providing contract R&D and related maintenance services on a cost plus basis
  - Shortly after the restructuring, XYZ raised funding at a substantial valuation
- **BEPS impact on the structure**
  - Valuation aspects of such transfers
  - Post restructuring transfer pricing model

Case study 2 (contd)
Key implications for I Co and XYZ Group

- **Pre-BEPS scenario**
  - Focus on legal ownership of IP meant that transfer of legal rights also resulted in transfer of underlying income from exploitation of IP
  - Contractual allocation of risks could result in characterizing I Co as a cost plus service provider
  - IP transferred early in life-cycle of its development at "nominal value" – e.g. development costs incurred

- **Key implications of the BEPS guidance:**
  - The valuation undertaken for transfer of IP by I Co can be re-validated by tax authorities having regard to the actual outcome post transfer. XYZ Group may have to remunerate I Co for differential profits
  - Movement of significant people function is critical along with IP transfer.
  - In the absence of transfer of key people functions, I Co would still be entitled for significant economic returns for the IP
    - XYZ Group to get "funding return" if the activity is only restricted to "funding";
    - A cost plus return for legal administrative functions;
    - In the absence of the economic substance/ functional capabilities at XYZ Group, I Co would receive significant economic returns from exploitation of IPs

Case study 3
Buy-sell arrangements



- Facts
  - D Co. is engaged in manufacturing of consumer goods; sold under 'X' brand. D Co is the Irish Principal/ global distributor of an MNE group
  - I Co. is routine distributor in India for D Co., which has the regional/ global distribution rights to manufacture and sell products with X brand
  - As per agreement, I Co. would be sole distributor of D Co. in India and would sell goods bearing brand 'X'
  - I Co. sold goods to retailers at a price so as to retain 3-4% margin
  - I Co. incurred significant advertising, marketing and promotion ('AMP') expenditure to promote products with 'X' brand in India
  - Promotion of brand 'X' was not part of distribution agreement

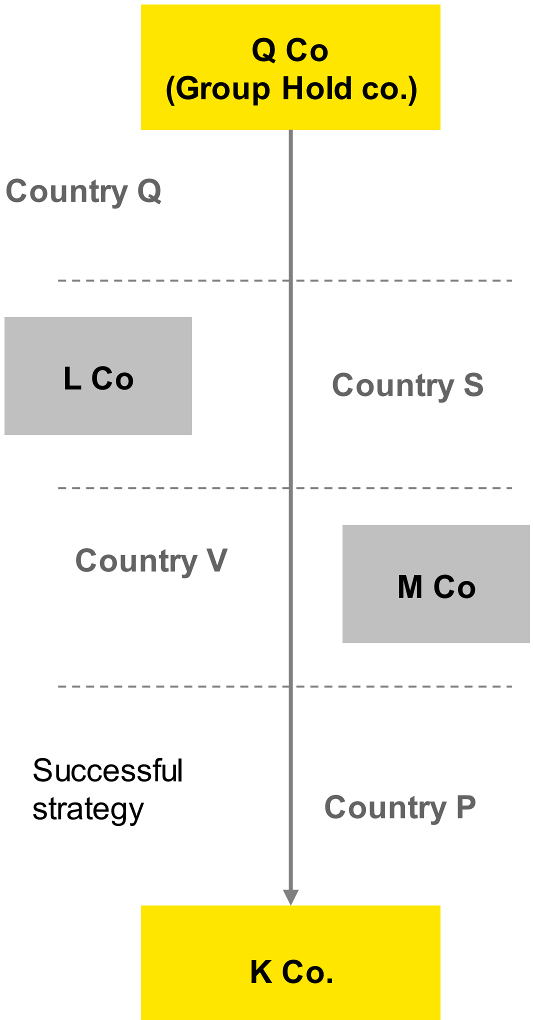
- BEPS implications from BEPS action plan 8-10:
  - How should I Co be compensated for its role as a distributor?

Marketing IPs

Determining the role of distributor and arm's length compensation

- **Pre-BEPS scenario**
  - Limited OECD guidance on issues relating to intangibles
  - Ambiguity/ uncertainty on legal as well as economic issues relating to TP aspects of promotional activities
  - Plethora of case laws in the Indian context; but still no clarity
- **Key post-BEPS implications:**
  - Attempt to identify wider range of marketing intangibles (beyond trademark/ tradenames) and to determine if I Co contributed to the development of marketing IPs owned by D Co.
  - Approach for compensation of I Co may vary having regard to the nature of distribution/ contractual arrangement
    - Long-term distribution agreement – No specific compensation may be warranted as marketing functions benefit I Co and enhances value of distribution rights
    - Cost plus remuneration for "non-routine" marketing spend identified in line with the objective/ rationale basis PLUS arm's length margin for distribution – more BLTs?
    - Arm's length margin for the overall operating model subsuming return for AMP function.

Case Study 4 – Strategy transfer



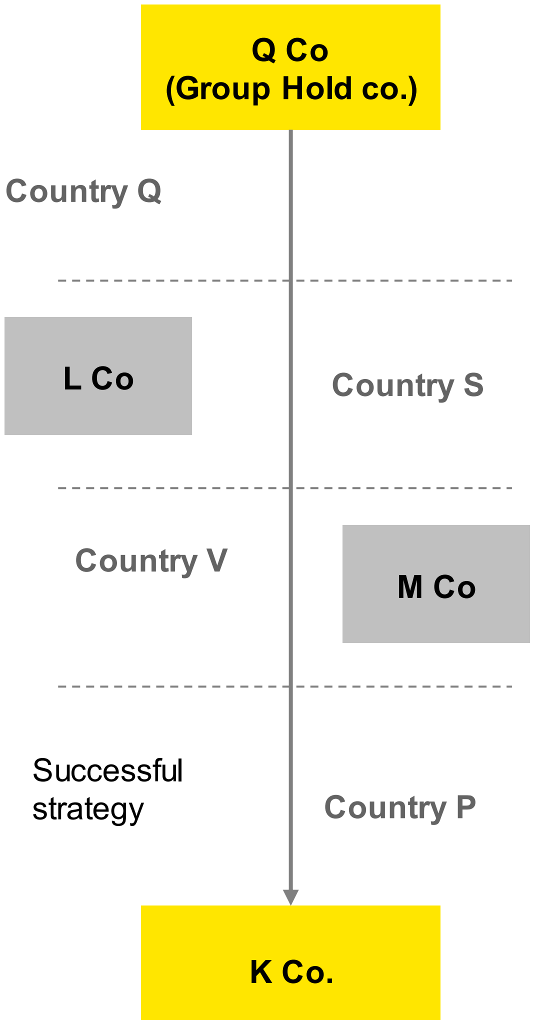
Facts:

- Q Co. is the holding company of the MNE group with L Co., M Co. and P Co. as its members
- K Co. Located in Country P has suffered persistent low margins
- L Co. and M Co. are high profit making companies and have been successful on account of a particular marketing strategy
- Q co. has documented the key factors of successful marketing strategy of L Co. and M Co.
- K Co. avails such strategy documentation from Q co. , for which it does not make any payment
- K co. implements such marketing strategy and makes additional profits to the tune of 5% points

Actions by tax authorities in Q co. jurisdiction:

- The tax authorities treated ‘strategy documentation’ as a intangible for transfer pricing purposes
- A TP adjustment is made for transfer of strategy documentation by Q Co. to K Co.
- Tax authorities in jurisdiction of Q Co. allocate 5% additional profit made by K Co. to Q Co.

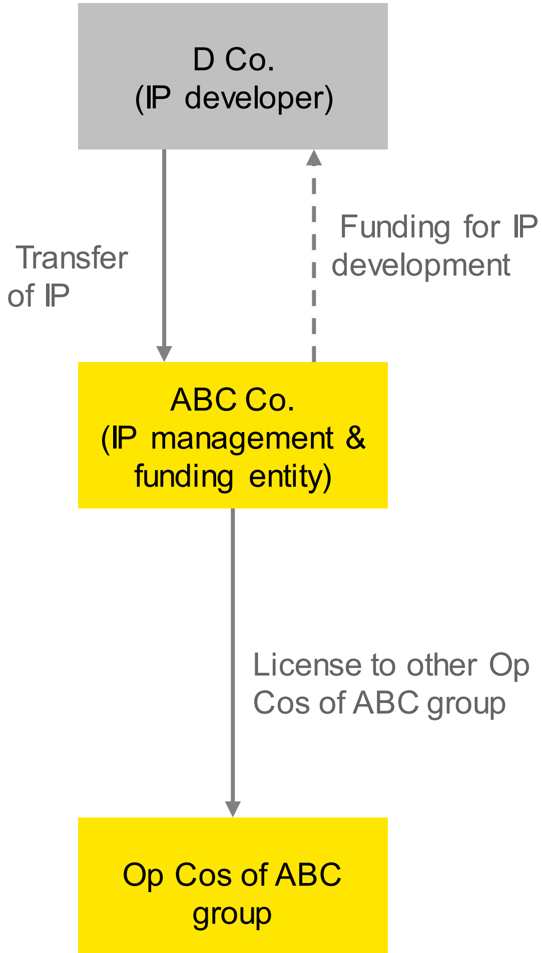
Case Study 4 – Strategy transfer (contd)



Key issues & considerations:

- Whether 'strategy' falls under the purview of definition of intangible asset as given by OECD Action 8 deliverable report?
  - Whether strategy can be owned or controlled by a particular enterprise?
- Whether TP adjustment made by tax authorities is correct?
  - Whether allocation of 5% incremental profit made by K Co should be attributable entirely to Q Co.?
    - Return for implementation function to K Co?
  - Whether remuneration on strategy transfer should be paid to L Co. or M Co. who devised the strategy, rather than Q Co. which documented success factors?
  - Whether incremental profit be split between Q Co., L Co. and M Co. as per their relative contributions?
- Whether transfer of strategy documentation was provision of service by Q Co. to K Co.?
  - No payment of service fee to Q Co. as benefit to K Co. was incidental benefit on account of existing strategy existing within group?

Case 5 - DEMPE Functions



Facts:

- ABC Co. was holding company of ABC group.
- ABC Co. funded D Co., it's AE, for development of IP
- On IP development, the ABC Co. was registered as legal owner of IP
- D Co. was remunerated for IP development on cost plus basis
- ABC Co. takes major decision on control and management of IP
- ABC Co. manages IP and licenses to operating cos of ABC Group and received royalty fees

Key issues & considerations:

- Whether ABC is entitled to royalty return on exploitation of IP by operating cos. of ABC group?
- Appropriate arm's length return to be paid to ABC Co. and D Co. on IP exploitation?
- Whether royalty payments should be split between IP co and ABC co. for IP development and other functions?

BEPS: Action 8-10 – Potential Impact

Action Plans 8-10: Potential impact

- Broad definition of intangibles requires reassessment of IP in the group and functional contributors to the IP
- Focus on marketing intangibles and more “bright line tests”
- Specific attention to be paid to transfer pricing aspects of location savings, other local market features and synergies
- If DEMPE contributors are remunerated on a one-sided basis, reliability of transfer pricing reduced
- Review value chain in light of new definitions to determine value contributing entities
- Additional scrutiny of TP for services – need to segment services into “low value add” and “not low value add”?
- Greater emphasis on parties’ commercial and financial conduct, notwithstanding characterization in inter-company agreements
- Contractual allocation of risk without sufficient control will not be regarded at arm’s length

BEPS: Action 13

Action Plan 13

Action 13 focuses on TP documentation and includes the CbC report. Large amounts of previously undisclosed data suggested to be made available to tax authorities

- Action 13 is designed to increase transparency by providing tax authorities with sufficient information to allow them to conduct transfer pricing risk assessments and consider whether groups have engaged in BEPS-type activities
- It requires companies to use a consistent three-tier framework for providing information on global allocation of income, economic activity and intercompany pricing across all of a company's global operations
- CbC reporting applies to multinational enterprises

Master file

High-level information about the MNE's business, transfer pricing policies and agreements with tax authorities in a single document available to all tax authorities where the MNE has operations

Local file

Detailed information about the local business, including related-party payments and receipts for products, services, royalties, interest, etc.

CbC report

High-level information about the jurisdictional allocation of profits, revenues, employees and assets

Action Plan 13 - CbCR template
Table 1 and Table 2

Table 1:

Tax jurisdiction	Revenues			Profit (loss) before income tax	Cash Tax Paid (CIT and WHT)	Current year tax accrual	Stated capital	Accumulated earnings	Tangible assets other than cash and cash equivalents	Number of employees
	Unrelated party	Related party	Total							
1.										
2.										
3.										
4.										
5.										

Table 2:

Tax jurisdiction	Constituent entities resident in the tax jurisdiction	Tax jurisdiction of organization or incorporation if different from tax jurisdiction of residence	Main business activity(ies)												
			R & D	Holding or managing IP	Purchasing or procurement	Mfg or production	Sales, marketing or distri.	Admin., Mgmt or support services	Provision of services to unrelated parties	Internal group finance	Regulated financial services	Insurance	Holding shares or other equity instruments	Dormant	Other
	1.														
	2.														
	3.														
	1.														
	2.														

Action Plan 13
Masterfile content as per Indian rules

Organization structure

Structure chart:

- List of all the entities along with their addresses
- Legal status and ownership

Business description

- Nature of business
- Important drivers of business profit
- Supply chain of:
  - Five largest products/ services by turnover
  - Products/services generating more than 5% of group sales
- Main geographic markets for the products/services
- Description of important service arrangements along with their capabilities
- Functional analysis of the entities that contribute at least 10% of the revenue, asset or property, profit of the MNE Group.
- TP policy for service cost allocation and pricing intra-group services
- Business restructuring/ acquisitions/ divestments during the financial year

Intangibles

- Overall strategy description
- List of entities (with address) engaged in development and management of intangibles
- List of important intangibles and legal owners
- List of important intangible/cost contribution/research/license agreements
- TP policy for R&D and intangible
- Details of important transfers

Intercompany financial activities

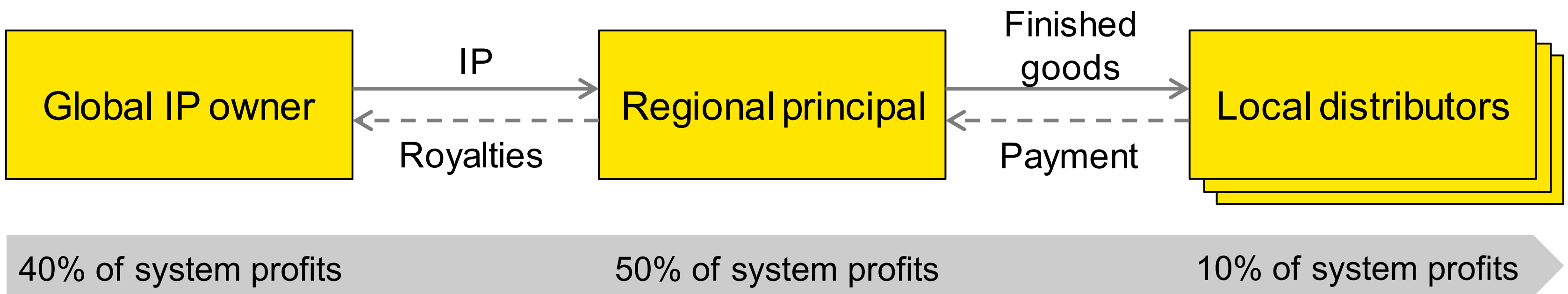
- Financing arrangements of the group, including names and address of top 10 unrelated lenders
- List of entities providing central financing functions with address of operation and effective management
- Details of financial transfer pricing policies

Financial and tax positions

- Annual consolidated financial statements
- List and description of existing unilateral APAs and other tax rulings

Highlight indicates deviations as compared to OECD's BEPS Action 13

Traditional TP/ supply chain planning



- Today - local jurisdictions only see local transactions – e.g. is distributor appropriately remunerated?

- Post-Action 13, all jurisdictions get full supply chain visibility, giving rise to wider exposure
  - Is distributor profitability artificially low because of IP transaction elsewhere?
  - What value addition does the regional principal do?
  - Does the IP owner have adequate substance?

Key considerations

Use of CbcR

- Jurisdictions with significant revenue / profits:
  - deviates from industry average
  - little substantial activity or vice-versa
  - low levels of tax accrued or vice-versa
    - Profit margin (PBT / total revenues v/s ETR)
    - Effective tax rate (income tax accrued / profit before tax)
    - Related party revenues / total revenues
- Revenue or profits per unit of economic activity (total revenues or PBT / number of employees or tangible assets)
- Activities located in jurisdictions where the group pays a lower rate or level of tax (Table 1 & 2)
  - Marketing entities not located in key markets
  - Procurement entities not located in key manufacturing locations
  - IP is separated from related activities within a group

Use of Master file

- Supply chain – Re-Invoicing companies
- Service arrangements – Consistency in pricing policy
- Geographic markets – Main Markets, anti-avoidance / DPT type legislation
- FAR analysis – Action 9 and contractual allocation of risk
- List of entities engaged in development and management of intangibles – Return based on function
- List of agreement on intangibles – CCA/ Royalty payment
- TP policy on intangibles – R&D Policy, R&D Credits
- Intercompany financial arrangement and treasury function – Profits belong to entity undertaking decisions

Questions?

Thank you!

CA Chirag Sheth