BEPS Action Points 8-10
Special focus on intangibles

1 June 2016

Skattevidenskabelig Forening

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Building a better working world

Agenda

1. Historic background
2. Action 8-10 Overview
3. New TP Approach for intangibles
4. Low Value adding services

Historic background

- OECD Transfer Pricing Guidelines 1995
  - Attempt to achieve a coordinated OECD approach following the 1994 US § 482 regulations
  - In 2006 the EU Code of Conduct on transfer pricing was issued within the framework of the OECD TP Guidelines
- OECD Transfer Pricing Guidelines 2010 (update of the Chapters I-III)
- UN Transfer Pricing manual 2012
- Draft on Intangibles (Chapter VI)
- Google, Starbucks, Amazon pops up in the media
- G20 countries initiate BEPS
  - Delegate to OECD to come up with action points to avoid aggressive tax planning
- Result: Action Point 8-10 and 13 (October 2015)

Action 8-10 overview

New transfer pricing principles (Actions 8-10)
Overview of the final report

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
- Legal ownership alone does not generate a right to the return generated by the exploitation of an intangible
- Focus on Development, Enhancement, Maintenance, Protection and Exploitation (DEMPE) functions
- Hard-to-Value Intangibles (HTVIs)
- Cost-Contribution Arrangements (CCAs)

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 Splits (work to be continued in 2016)
- Recognition of transactions
- Commodity transactions

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New TP approach for intangibles

Consequences of BEPS

- Increased focus on:
  - Value creation – where is the value created. Coherence between value creation and income generation
  - Substance – who makes decisions and who controls and assumes risk
  - Transparency – increased focus on tax planning

Before BEPS

- 1995 OECD Guidelines emphasised that pricing under the Arm's Length Principle (ALP) is dependent on:
  - Functions performed
  - Risks assumed, and
  - Assets employed
- Provide tax planning potential by a contractual *separation* of risks/intangibles from functions
  - Functions remained in high-tax country
  - Risks/intangibles relocated to low-tax country
- Remuneration
  - Functions: Cost plus basis
  - Risks/intangibles: Residual profits
- Low effective tax rate/base erosion in high-tax country

“New” arm’s length principle

- Two key changes to the ALP
  - Risk allocation
  - Intangible profit allocation (who contribute to the value)
- ALP is conceptually transformed:
  - 1995: Pricing standard – prices must be arm’s length
  - 2015: Pricing and substance-over-form standard – both prices and the controlled transaction in itself must be arm’s length

“New” arm’s length principle

- Risk allocation
  - Contractual risk allocation recognised under 1995 Guidelines

  - Separate arm’s length test of risk allocation under 2015 Guidelines
    - “Actual conduct of the parties” is decisive – determined based on:
      - 1) Control over risk, and
      - 2) Financial capacity to assume risk

  - Contractual risk allocation is *disregarded* if inconsistent with the “actual conduct of the parties”

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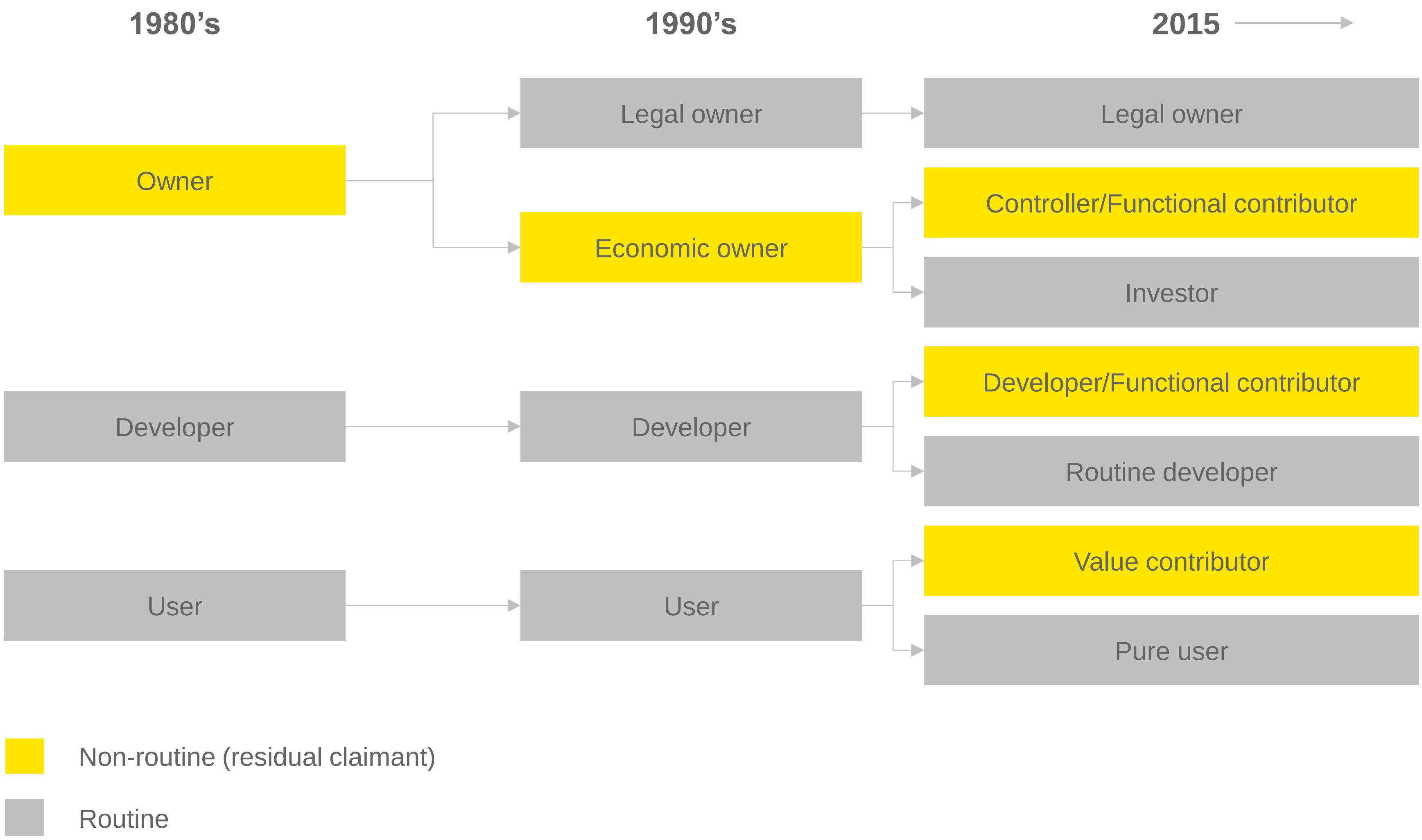
Changing perceptions of entitlement to profit from intangibles



“New” arm’s length principle

- Intangible profit allocation:

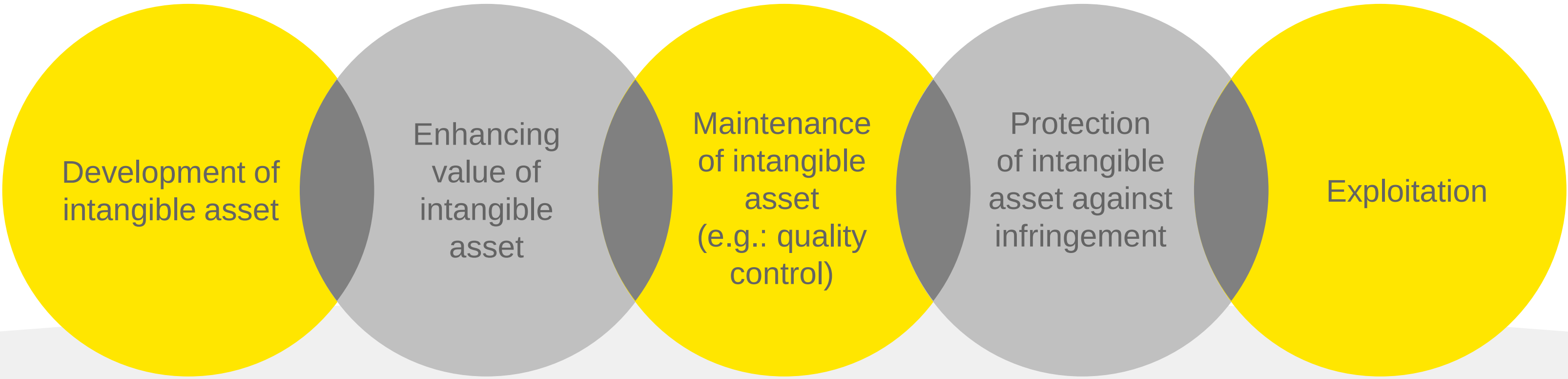
  - Enterprises that **contribute to the value of the intangible** must receive arm’s length compensation:
    1. **Functions**: “Important” functions relating to the development, enhancement, maintenance, protection and exploitation (DEMPE) of an intangible are *deemed* to be valuable and unique
    2. **Risks**: Allocation based on the “actual conduct of the parties”
    3. **Assets**: Funding profits capped at a risk-adjusted or risk-free return

    4. Comparable uncontrolled transactions are *presumed* not to exist due to the uniqueness of the “important” functions, and
    5. A transfer pricing method is applied that shifts a significant share of profits to the enterprise that performs “important” functions and is exercising control over the risks, e.g. the profit split method

  - Legal owner may be left with anything from 0% to 100% of profits

DEMPE functions and entitlement to intangible return

- OECD focus is on Development, Enhancement, Maintenance, Protection and Exploitation (DEMPE) functions relating to intangible assets



- Requirement to directly perform or to control the performance of DEMPE functions and related risks
- 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

Example of “old approach”

IP Owner
Denmark
R&D department
Decision makers

Contract R&D services

Funding R&D development

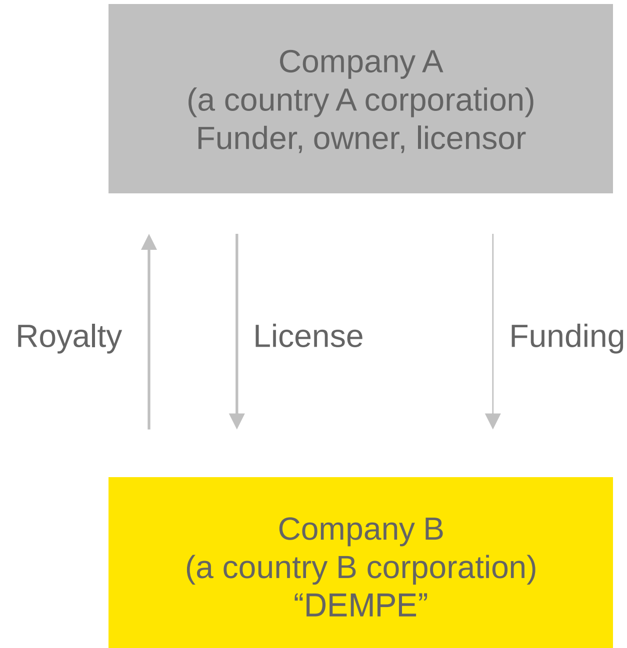
Taking risk of failure

New IP owner/risk taker
No decision makers/no people that can control the risk
Switzerland

- Decision maker and able to control the risk – (significant higher remuneration - residual claimant)
- Cannot be residual claimant - only entitled a risk free return or risk adjusted return on the funding

Application of the arm's length principle Example 6 (The Report pp. 119-120)

- Group decides to develop an intangible
  - Expected to be highly profitable based on B's existing intangibles, its track record and its staff
  - 5 years development & 10 years exploitation
- The intra-group agreement
  - B to develop, enhance, maintain, protect and exploit the intangible – functionally and by control
  - A to provide funding – this is expected to be USD 100m per year for 5 years – and assume ownership
- The anticipated upside
  - USD 550m per year for 10 years (intangible's return)
  - B to license the intangible from A against payment of royalty (assumed comparability)
  - B expected to earn USD 200m per year (USD 440m)



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DEMPE functions and entitlement to intangible return

- Functions which have special significance for purpose of functional analysis while arriving at arm's length compensation:
  - Design and control of research and marketing programmes
  - Management and control of budgets
  - Control over strategic decisions regarding intangible development programmes
  - Important decisions regarding defence and protection of intangibles
  - Ongoing quality control over functions performed by associated enterprises that may have a material effect on the value of the intangible
- The return to mere funding may be limited to a risk adjusted, forward looking, return on capital

The new OECD guidance has moved away from concept of ownership, and has adopted an approach looking at who is contributing to the value of the intangible, i.e. a clear focus on 'substance' for conducting TP analysis of intangibles

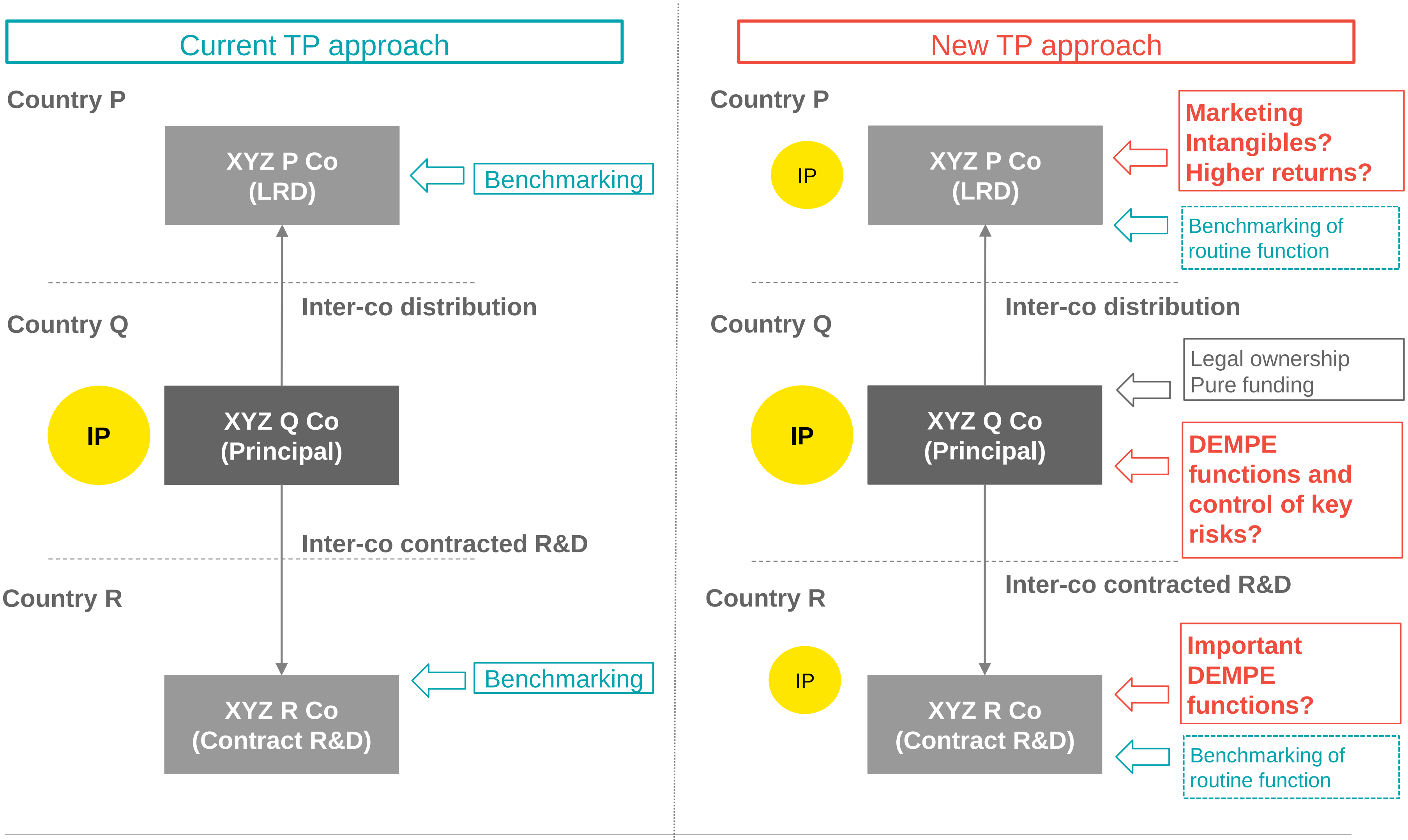
Identifying and defining intangibles

"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 …"

Goodwill & going concern	▸ Relationship Capital (innovation community, ecosystem and supply chain partnerships) ▸ Reputational value ▸ Key Human Capital	**However, OECD Action 8 guidance explicitly excludes:** ▸ Group synergies ▸ Market specific characteristics
Other intangible related returns	**Non-registered IP (illustrative examples)** ▸ Know-how and trade secrets ▸ Marketing intangibles ▸ Distribution network and customer lists ▸ Product design and technology ▸ Process technology provided to buyers ▸ Supplier lists and procurement processes	**TP 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, know-who, copyright in software code
Separately identifiable intangible assets	**Registered IP (illustrative examples)** ▸ Patents, designs, licences and rights ▸ Trademarks, names, domain names and brands ▸ Other contractual rights	**Are you in a position to identify all the intangibles and IP owned, controlled or used in your business ?**

DEMPE functions

What does it mean for Principal models?



Questions and Comments

- Is the “new” ALP a good solution?
  - BEPS potential not eliminated – now functions (people) must be transferred rather than intangibles and risks – potentially no exit taxation
  - Causes great uncertainty for taxpayers
  - Increase tax compliance burdens
  - Boost number of cross-border tax disputes

Low Value-Adding Services

Action 8-10 – Low Value-Adding Services

- The following bullet points provide examples of services that **would** likely meet the definition:
  - Accounting and auditing
  - Processing and management of accounts receivable and accounts payable
  - HR (staffing, recruitment, training and employee development)
  - Monitoring and compilation of data relating to health, safety, environmental and other standards regulating the business
  - IT services where they are not part of the principal activity of the group
  - Communication, PR and general services of an administrative or clerical nature
  - General legal services and activities with regard to tax obligations

- The final report introduces an elective, simplified approach for low-value adding services:
  - A process for determining the <u>costs</u> associated with low value-adding services
  - Allowing general <u>allocation keys</u>
  - A <u>simplified benefits</u> test
  - A standard moderate <u>5% mark-up</u> (no benchmarking study needed)

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Action 8-10 – Low Value-Adding Services

- The following bullet points provide examples of services that **would not** meet the definition of low value adding services:
  - Core business of the entity
  - R&D services (including software development)
  - Manufacturing and production services
  - Purchasing activities relating to raw materials or other materials that are used in the manufacturing or production process
  - Sales, marketing and distribution activities
  - Financial transactions
  - Extraction, exploitation or processing of natural resources
  - Insurance and reinsurance
  - Services provided by the corporate senior management