Global Transfer Pricing Conference
Substance, intangible property, and current issues around permanent establishments
October 2013
Presenters

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Permanent Establishment:
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Intangibles:
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Introduction

OECD BEPS action plan and Substance

Permanent establishments – latest developments and key issues

Intangibles – latest development and key issues

Case studies

Takeaways
Introduction

• An impact of the OECD BEPS Action Plan on Substance
• Definition and importance of Substance in the context of intangibles and permanent establishments
**OECD BEPS action plan**

**Overview**

- **June 2012**: Project announced / started
- **February 2013**: Release of document, ‘Addressing Base Erosion and Profit Shifting’
- **July 2013**: Release of Action Plan with 15 separate actions/work streams
- **September 2014**: Projected completion of approximately ⅓ of Action Plan
- **December 2015**: Completion of remainder of Action Plan
- **2016 and forward**: Monitoring, additional/on-going actions

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# OECD BEPS action plan

## Actions

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<thead>
<tr>
<th>No</th>
<th>Action</th>
<th>Area of focus</th>
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<tbody>
<tr>
<td>1</td>
<td>Address the tax challenges of the digital economy</td>
<td>Digital economy</td>
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<td>2</td>
<td>Neutralise the effects of hybrid mismatch arrangements</td>
<td>Coherence (Hybrids)</td>
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<td>3</td>
<td>Strengthen CFC rules</td>
<td>Coherence (CFCs)</td>
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<td>4</td>
<td>Limit base erosion via interest deductions and other financial payments</td>
<td>Coherence (Debt)</td>
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<td>5</td>
<td>Counter harmful tax practices more effectively, taking into account transparency and substance</td>
<td>Coherence (‘Deals’)</td>
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<td>6</td>
<td>Prevent treaty abuse</td>
<td>Substance (Treaty)</td>
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<td>7</td>
<td>Prevent the artificial avoidance of PE status</td>
<td>Substance (PE)</td>
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<td>8</td>
<td>Assure that transfer pricing outcomes are in line with value creation: Intangibles</td>
<td>Substance (TP)</td>
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<td>9</td>
<td>Assure that transfer pricing outcomes are in line with value creation: risks and capital</td>
<td>Substance (TP)</td>
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<td>10</td>
<td>Assure that transfer pricing outcomes are in line with value creation: other high-risk transactions</td>
<td>Substance (TP)</td>
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<td>11</td>
<td>Establish methodologies to collect and analyse data on BEPS and the actions to address it</td>
<td>Transparency (Data collection)</td>
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<td>12</td>
<td>Require taxpayers to disclose their aggressive tax planning arrangements</td>
<td>Transparency (Schemes)</td>
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<td>13</td>
<td>Re-examine transfer pricing documentation</td>
<td>Transparency (Documentation)</td>
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<td>14</td>
<td>Make dispute resolution mechanisms more effective</td>
<td>Transparency (Disputes)</td>
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<td>15</td>
<td>Develop a multilateral Instrument</td>
<td>Multilateral instrument</td>
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More detail on each action is set out in Appendix 1

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Substance in pre-BEPS tax environment

- ‘Substance over form’ concept
  - Except where form controls
- ‘Economic substance’ doctrine
  - Business purpose/economic purposes
  - Disregarded transactions

- Economic substance of transactions
  - Conduct of parties and their functional and risk profiles
  - Re-characterisation in exceptional circumstances
**BEPS Action plan – importance of Substance**

Preamble to Action Plan

“Fundamental changes are needed to **effectively prevent double** non-taxation, as well as cases of no or low taxation ...that **artificially segregate taxable income from the activities that generate it**”

“A realignment of taxation and relevant substance is needed to restore the **intended effects and benefits of international standards**...”

... in the context of treaties and transfer pricing
OECD BEPS Action 6

Prevent treaty abuse

- “Develop model treaty provisions and recommendations regarding the design of domestic rules to prevent granting of treaty benefits in inappropriate circumstances.
- Work will be done to clarify that tax treaties are not intended to be used to generate double non-taxation...
- .... and to identify the tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty.”

What substance related measures are we anticipating?
OECD BEPS Action 8-10
Assure transfer pricing outcomes are in line with value creations

Action 8 – Intangibles

• “Adopting a broad and clearly delineated definition of intangibles
• **Ensuring profits associated with the transfer and use of intangibles are appropriately allocated in accordance with (rather than divorced from) value creation**
• *Developing TP rules for transfer of hard-to-value intangibles*
• **Updating guidance on cost contribution arrangements**”
Risk and capital

- “Develop rules to *prevent BEPS by transferring risks* among, or *allocating excessive capital* to, group members.

- *This will involve adopting transfer pricing rules or special measures to ensure that inappropriate returns will not accrue to an entity solely because it has contractually assumed risks or has provided capital.*

- *The rules to be developed will also require alignment of returns with value creation.*”

What substance related measures are we anticipating?
**OECD BEPS Action 13**

Re-examine transfer pricing documentation

- “… include a requirement that MNEs provide all relevant governments with needed information on their global allocation of the income, economic activity and taxes paid among the countries according to a common template.”

- **OECD White paper on TP documentation**
  - Two tiered approach – ‘big picture’ information vs local requirements

- **OECD Memorandum on TP documentation and country by country reporting**
  - Measures of economic activity

What substance related disclosures are we anticipating?
What next?

• Alignment between substance and returns?

• Understand potential exposure/mitigating measures

• What are ‘value creating functions’? Where are they based?

• Impact of future disclosure requirements?
**Permanent establishment**

BEPS Action Plan

- Action 7 under the Action Plan - “Prevent artificial avoidance of PE status”:
  - Commissionaire arrangements
  - Fragmentation of activities to qualify for exemptions in Art 5(4)

- A PE definition to cover taxation of the digital economy?

- Potential revision of the OECD Guidance on the Attribution of Profits to a PE

- 2012 Revised OECD Report on Interpretation and application of Article 5
**Permanent establishment**

2012 revised discussion draft

- The discussion drafts deal with the following key areas:
  - Meaning of the phrase ‘to conclude contracts in the name of the enterprise’
  - Independent agent status - commissionaire
  - Place of management PEs
  - Presence of visiting employees/secondments
  - Home office as a PE

- During the most recent discussions of the OECD there has been a perceptible shift on the interpretation of the dependent agent rule as including situations where the principal is ‘economically bound’ by the agent
Permanent establishment
Issues to consider for areas of risk

• Size of direct tax exposure based on the 2010 ‘Attribution of profits to PEs’ report
• Tax due, penalties and interest
• Filing requirements
• Prior years position
• Knock-on effect relating to other taxes - a PE for VAT or employment tax purposes?
• Knock-on effect for the same type of tax - knock-out the availability of treaties due to the PE? Any other tax charges triggered by the existence of a PE?
Permanent establishment
Likely areas of required focus

Direct Tax – inadvertent PE exposure

Fixed place of business PE
- Local staff PE assessment
- Local equipment – servers, machines etc

Dependent agent PE
- Travelling/visiting employees PE assessment
- Sales related activities – commissionaires, agents, sales support
- PE assessments of services under contract or outside contractual arrangements

Service PE
- Travelling/visiting employees PE assessment

Digital PE?
- Digital economy/web-based business

Unique country rules
- PE assessment as dictated by local rules

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**Intangibles**

OECD Initiatives Related to IP Migration

**Base Erosion and Profit Shifting (BEPS)**

- Released **BEPS Report** February 2013
  - Endorsed by members of G20, addresses concerns of reduced tax revenues stemming from corporate tax planning aimed at eroding taxable income by shifting profits to location with favorable tax treatment
  - Identified TP as a “key pressure area” involving the treatment of risks and intangibles
    - Rather, key factor is the location where material functions related to intangible assets are being performed
    - Focus is on “functional value creation” and the concept of “important functions”
**Intangibles**

OECD Initiatives Related to IP Migration (cont.)

**Base Erosion and Profit Shifting (BEPS) (cont.)**

- **Released BEPS Action Plan** on July 19, 2013
  - Emphasis on aligning profits with “value creation”; perception that current international tax system has flaws that create dissonance between the two
  - Sets forth 15 separate action points, including ensuring TP outcomes are in line with value creation – intangibles, risk and capital, and other high-risk
    - To clarify circumstances in which high-risk transactions would be recharacterized to prevent base erosion
  - Suggests that “special measures” beyond the arm’s length standard may be required to address perceived flaws in the system relating to intangibles, risks, and overcapitalization
Intangibles
OECD Initiatives Related to IP Migration (cont.)

Revised Discussion Draft on Intangibles

- Released Revised Discussion Draft on Intangibles July 2013
  - Key changes include:
    ◦ Clarifies definition of intangibles;
    ◦ Takes more transactional approach to ownership;
    ◦ Streamlines guidance on comparability;
    ◦ Provides examples on valuation techniques;
    ◦ Reserves further work on “hard to value intangibles” under BEPS; and
    ◦ Includes new provisions on local market features and group synergies
  - Importantly, takes a more flexible position on intangible related returns, positing that the funder may outsource all functions yet be entitled to “retain returns related to funding and risk”
Intangibles
OECD Initiatives Related to IP Migration (cont.)

Revised Discussion Draft on Intangibles (cont.)

• **Definitional issues** revolve around:
  - Goodwill, ongoing concern, workforce in place
    - First two are generally intangibles; WIP may be depending on what kind of value in the workforce is transferred
  - Location savings, group synergies, market premiums continue to be comparability adjustments but are given great consideration in the draft, a nod to non-observing members such as China

• **Valuation issues** indicate a bend towards:
  - Application of residual profit split method, and critique of other methods
  - Determination of arm’s length valuation when value of intangibles is highly uncertain *ex ante*
  - Recognition that tax authorities have better information *ex post*
Intangibles
Intangible-related returns

Allocation of intangible-related returns (cont.)

• Perform important functions related to the development, enhancement, maintenance and protection of intangibles, including providing all assets and bearing and controlling all risks related thereof

  1. Design and control of research and marketing programs;
  2. Management and control of budgets;
  3. Control over strategic decisions regarding intangible development programs;
  4. Important decisions regarding defense and protection of intangibles; and
  5. Ongoing quality control over functions performed by independence or associated enterprises that may have material effect on value of the intangibles

• Slant towards Article 7 /Article 9 functional approach

• Assumption of financial risk versus control risk – entitlement to risk-adjusted return

• E.g., the mere fact that a Swiss entity “on paper” is the HubCo would not entitle it to intangible related returns; however, the people functions would be entitled to some profit
Question for the audience

Which case study would you like to discuss first?

1. Technology group
2. Consumer product group
3. Pharmaceutical group
4. Digital economy/ online services
5. E-tailer
**Case study 1 – Technology group**

**Facts**

- U.S. Co
  - Owns IP for products X and Y
  - Licenses the right to manufacture and distribute product X to Cayman Co (US only) and Swiss Manufacturing Co (outside the US)
  - Licenses the right to manufacture and sell worldwide to Cayman Co
  - Entered into Cost Sharing Agreements with Swiss manufacturing Co for product X
  - Performs all R&D for products X and Y
  - Manufactures all product components
  - Distributes products within the US

- Swiss HoldCo
  - Licenses the right to manufacture and distribute products X and Y

- Cayman Co
  - Fully fledged manufacturer for X and Y
  - Only a few employees based in the Cayman Islands
  - Buys components at cost plus 17%
  - Sells finished product X to the US
  - Sells finished product Y worldwide

- U.S. Co
  - Purchases components
  - CSA for X

- Swiss Manufacturing Co
  - Sells product to customers outside the US
  - 2% commission fee

- Commissionaires
  - Buys into the existing and payment for the future IP for X
  - Sells all manufactured products to Swiss Commissionaire Co

- Foreign Customer
  - Purchase of components

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Case study 1 – Technology group
Potential risk areas

- Sale of product to customers
- Purchase of components
- CSA for X
- Sale of product
- 2% commission fee
- 4. Is a distribution margin earned by the US arm’s length?
- 5. A dependent agent PE of SwissCo?

1. IP, manufacturing and distribution related returns split between the US and Cayman arm’s length?
2. Is the price of components arm’s length?
3. Is the annual CSA contribution arm’s length?
Case study 2 – Consumer product group

Facts

- CPG group, headquartered in the US
- Principal in Switzerland to manage operations outside US; it pays a license fee to the US for the use of intangibles
- Swiss Principal employs: 10 finance staff and the Global Head of Manufacturing (a US expat).
- Distributors in Europe operate via the commissionaire structure
- In the US and China, the group operates via a limited risk buy sell model distribution model
- Most of the goods are manufactured in Mexico and China
- Employees of the Principal Co regularly work on the UK Commissionaire’s premises
- A Swiss executive is seconded to China
Case study 2 – Consumer product group
Potential risk areas

1. IP related returns?
   - Parent (US)
   - Management fee payment
   - Principal Co (Switzerland)
   - ‘Swiss finance staff regularly work in the UK
   - IP license payment

2. Dependent agency PE?
   - Sales commissionaire (Europe)
   - Low cost manufacturer (Mexico)

3. Location savings issues?
   - Low risk distributor (US)
   - Distributor and manufacturer (China)

4. Tested party? Level of return?
   - ‘Secondment’ of a senior executive

5. Management fee related risks?
   - 5.

6. Fixed Establishment for VAT of SwissCo in the UK?
   - 6.

7. Income tax liability of Swiss execs in the UK?
   - 7.

8. Service PE risk?
   - 8.
Case study 3 - Pharmaceutical group

**Facts**

- **Contract R&D:**
  - has approx. 1,000 employees
  - designs research programs
  - develops & controls budgets
  - performs R&D
  - monitors progress of R&D
  - decides modification or termination of R&D projects

- **IP Co:**
  - Has 5 employees who are responsible for IP, namely for: development, enhancement, protection, maintenance and exploitation
  - Global Head of manufacturing and Logistics
  - Incurs the cost of the R&D activities

- **UK HQ:**
  - Operations planning and negotiations of sales contracts involve UK HQ executives
Case study 3 - Pharmaceutical group
Potential risk areas

1. PE risk?
2. A character of the fee
3. A level of IP related return
4. Economic ownership of P

Parent Co (US)

Contract R&D (India)

IP Co and Supply Chain Co (Ireland)

UK HQ

Contributes $50 million

5. Level of substance in IPCo in Ireland – split of IP returns with India?
6. Split of Supply chain returns between Ireland and the UK?
7. Place of management PE?
8. Dependent agent PE?
9. Fixed establishment for VAT?
10. TP issues re: management fee
Case study 4 – Digital economy/online services

Facts

- Principal Co licenses the rights to use the technology from IP Co. A large number (1,000+) of staff employed in this entity who are involved in
  - Sales
  - Product development
  - IT platform development and maintenance

- Support services provided by affiliates to the Principal Co:
  - Marketing support and promotion
  - Providing education/training to clients
  - Product R&D

- Principal Co and UK & the European Market has a contract for purchase of advertising on auction basis with prices set by the platform

- UK/European customers buy from the Principal Co – but Service personnel involved in negotiations of some (non-automated) contracts
Case study 4 – Digital economy/online services
Potential risk areas

1. TP – split of the IP related returns between Ireland and Bermuda

2. Action 1 – Digital economy – basis of taxation of Irish Co in the UK for UK sales – PE or Indirect tax route?

3. Europe 2015 – changes to the VAT Rules re: on-line sales

4. Agency PE if UK staff involved in negotiation of contacts

5. Level of reward to the UK? With or without a PE?
Case study 5 – E-tailer

Facts

- E-tailer sells products via the Luxembourg based trading company
- In some countries the Lux e-tailer owns its servers and sells via websites on its servers to local consumers
- In some countries the e-tailer sells to local consumer via websites on hosted servers
- Stock owned by the e-tailer in owned or 3rd party warehouses
- Warehouses cover a cluster of countries to guarantee provides sales support/fulfilment staff based locally
Case study 5 – E-tailer
Potential risk areas

1. PE of the e-tailer?
2. Attribution of profits

A server in the country of consumers (owned)

Parent (UK retail group)

Retailer (UK Co)

Consumers

Warehouses

3. PE of the e-tailer?
4. Attribution of profits

A website on a hosted server in the country of consumers

5. Does a 5(4) exception apply?
6. Level of reward?

7. FE for indirect tax?
Takeaways
What do we need to do next?
What next?

How confident are you that the substance aligned with where profits are allocated and taxis paid?

- Understand a global value chain
- Understand where senior executives (‘important people functions’) are located
- Compare locations where tax is paid with locations where senior executives are based - are they aligned?
  - Impact on profits allocation of IP related returns?
  - Does the misalignment result in a PE exposure?
What next?
A suggested approach to a PE review

1. Based on the agreed scope design / specification of detailed PE review by business line / by country / by PE rule

2. Detailed analysis of facts (including review of documentation, procedures, interviews / fieldwork as necessary etc) by reference to detailed PE rules

3. Conclusions on PE issues / exposures (by business line, country, type of rule) and quantification of the exposure

4. Address and deal with identified issues. Remediate issues/exposures

- Systems/Process change
- Process Guidance Notes
- Guidelines (incl Do’s and Don’ts Notes, etc)
- Training / education

Country specific factual data

Check across to taxable presence related issues – income tax / VAT / visas and immigration as relevant

Detailed PE Technical rules – and detailed rule variations by country
What next?
Key issues concerning the Intangibles

Use of alternatives to the arm’s length standard?

Increased focus on Substance

More disclosure requirements

Scrutiny around return on risk

Return on intangibles
Questions?