Interaction of TP with 367 analyses, PE and customs in controversy – key controversy arguments considering your TP positions
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Agenda

► Interaction of transfer pricing (TP) with Section 367(d)
► Controversy: permanent establishment (PE)
► Controversy: customs
Interaction of transfer pricing with Section 367(d)
The IRS reads the definition of intangible property (IP) under §936(h)(3)(B) very broadly to include goodwill, going concern and workforce-in-place.

The IRS maintains that goodwill and going-concern value have foreign and domestic components.
Why is definition of “intangible” for purposes of Sec. 936(h)(3)(B) important?

► Definition of “intangible” for purposes of Sec. 936(h)(3)(B) governs for purposes of application of 367(d).
► 1.482-4(b) defines “intangible” for purposes of 482; language closely tracks Sec. 936(h)(3)(B).
► Sec. 367(d) governs recognition of gain on cross-border transfer of “intangibles” through a Sec. 351/361 transaction.
► 1.482-7 (1995) governs cost sharing arrangements (CSAs) prior to 5 January 2009.
  ► 1.482-7(g) requires buy-in payment if “pre-existing intangible” made available to other participants in CSA.
  ► 1.482-7T (effective 5 January 2009) does not limit compensation obligation to “intangibles.”
  ► 1.482-7T solidifies movement toward valuation approach and includes disconnect between valuation and transfer pricing concepts.
Definition of Intangible under Section 936(h)(3)(B)

(B) Intangible property – the term “intangible property” means any:

(i) Patent, invention, formula, process, design, pattern or know-how
(ii) Copyright, literary, musical or artistic composition
(iii) Trademark, trade name or brand name
(iv) Franchise, license or contract
(v) Method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list or technical data

Or

(vi) Any similar item which has substantial value independent of the services of any individual
Implications of comparison of Sec. 936(h)(3)(B) and 1.482-4(b)

► Although the IRS could have adopted a broader definition of “intangible” for purposes of application of arm’s-length standard, it chose not to do so.

► The only significant difference between the two definitions is the addition to 1.482-4(b) of the following: “For purposes of section 482, an item is considered similar to those listed in paragraph (b)(1) through (5) of this section if it derives its value not from its physical attributes but from its intellectual content or other intangible properties.”

► To the extent this phrase expands definition of “intangible,” it can apply only to arm’s-length standard, not to commensurate with income (CWI) standard.
Limits of definition of “intangible” under Sec. 936(h)(3)(B)

► Many have argued that goodwill, going-concern value and workforce in place (GW, GCV and WIP) are not “intangibles” for purposes of Sec. 936(h)(3)(B).

► The implication is that any calculation of the arm’s-length amount of a buy-in payment under 1.482-7(g) or of the payments required under Sec. 367(d) should be reduced for the value attributable to GW, GCV and WIP.

► Also, specified methods that attempt to value transfer of IP by looking to transfer of projected income in the aggregate (e.g., the income method) become less reliable because must separately calculate and subtract value of GW, GCV and WIP.

► In Sec. 936 conversions, no value was given to intercompany license.
Some arguments as to whether GW, GCV and WIP are “intangibles”

► Issue complicated due to convoluted history of Sec. 936(h)(3)(B), Sec. 367(d), 1.482-4(b) and various other regulations and reports

► Some key relevant arguments and counterarguments
Arguments that definition of “intangible” does not encompass GW, GCV and WIP (plus counterarguments)

- GW, GCV and WIP are not specifically listed as “intangibles” in Sec. 936(h)(3)(B).
  - IRS counterargument – there are listed items that are “similar” to GW, GCV and WIP.
    - Goodwill and “customer lists” or “brand names”
    - Going-concern value and “methods,” “systems,” “procedures”
    - Workforce in place and “know-how”
- Certain treasury regulations presume that GW and GCV are not in Sec. 936(h)(3)(B) (but silent on WIP).
  - 1.861-9T(h)(1)(ii) refers to “any property as defined in section 936(h)(3)(B) or goodwill or going-concern-value intangibles”
  - 1.954-2(e)(3)(iv) similar
  - IRS counterargument: IRS is permitted to use “belts and suspenders” in drafting regulation
Arguments that “intangible” does not encompass GW, GCV and WIP (plus counterarguments)

- In order to be “intangible,” must have substantial value independent of the services of any individual. GCV and WIP are not really separable from services of individuals so should not be intangibles.
  
  Note: The IRS believes it is harder to make this argument for GW.

  The IRS counterargument: This reading presumes requirement to be that intangible must have value independent of the services of all individuals. If this reading were correct, “know-how” could not be intangible. IRS reading is that intangible must have substantial value independent of the services of any one individual. Consequently, GCV and WIP can be within the definition of “intangible.”
IRS argument that “intangible” does encompass GW, GCV and WIP (plus counterargument)

► Legislative history of Sec. 367(d) indicates that Congress was concerned that “foreign” GW and GCV not be taken into account in determining value of intangibles transferred to newly organized foreign corporation.

► This is reflected in the special provision excluding “foreign” GW and GCV at 1.367(d)-1T(b) as defined in 1.367(d)-1T(d)(5)(iii).

► (I.e., residual value of business outside of US after all other tangible and intangible assets have been identified and valued)

► IRS’ view is this makes sense only if GW and GCV are within the definition of “intangible” for purposes of Sec. 936(h)(3)(B).

► Counterargument: Congress was merely being cautious
Supply chain planning

- Case studies indicate increased scrutiny over outbound transfers.
  - For example, *Western Union* case/First Data Technical Advice Memorandum (TAM) 200907024 (released 13 February 2009)
  - Creative IRS approaches toward identifying intangibles

- IRS position on outbound transfers
  - Position 1: countries outside of US are performing cost-plus services and should only receive a routine cost-plus return.
  - Position 2: if first position does not hold, IRS contends that the new profit center established outside of the US is a result of an intangible transferred from the US.
  - Position 2 leads to incomplete Form 926 argument.

- Message:
  - Keep detailed transfer pricing documentation of the value drivers for the offshore affiliates’ arm’s-length returns
  - Document all intangibles transactions when engaging in new supply chain initiatives
Case: Zimmer Holdings Inc. v. Comm’r. (2014)

► Background:
  ► Zimmer Holdings Inc. (Zimmer) is a medical devices company based in the US.
  ► Zimmer Manufacturing B.V. (Zimmer Manufacturing), a Dutch subsidiary, produces medical products through its Puerto Rico operations under licensing agreements.

► The issue revolves around the appropriate compensation for Zimmer based on the licensing and manufacturing transactions between Zimmer and Zimmer Manufacturing, and the functions and risks associated with these transactions.

► The IRS determined a deficiency of $79 million in §482 adjustments for 2005-07.

► The IRS has taken three different positions in this case:
  ► Relied on the comparable profits method (CPM) for its main position under section 482
  ► Alternative position is $265.7 million income adjustment for 2006 and 2007 under section 367(d)
  ► Second alternative, $998.6 million income adjustment under section 367(a)(1)

► On 13 August 2014, Zimmer filed a petition maintaining that the IRS’ primary transfer pricing adjustment, under §482, is wrong because its intercompany pricing is at arm’s length. Under its intercompany agreements, Zimmer Manufacturing assumes all risks associated with the production of medical products and indemnifies the parent company for all liabilities, losses, claims and costs.
Controversy: permanent establishment
BEPS Action 7
Preventing the artificial avoidance of PE status
Contents

1. Background
   ► PE concept
   ► Organisation for Economic Co-operation and Development (OECD) Base Erosion Profit Shifting (BEPS) context
   ► Action 7 PE discussion draft

2. Commissionaire and similar arrangements
   ► What is the OECD’s concern?
   ► PE case law
   ► OECD’s proposed changes
   ► Overview of impact should the proposals be adopted

3. Use of specific activity exemptions

4. Profit attribution and transfer pricing
   ► What are the issues?
   ► The Authorised OECD Approach (AOA)

5. What should you do next?
1. Background
Background

PE concept – overview of recent developments

► Article 7 OECD Model Tax Convention
► Two-step approach:
  1. Hypothesize the PE as a distinct and separate independent enterprise
  2. Determine the profits of the hypothesized enterprise based on a comparability analysis

► Practical application of PE definition has raised a number of issues and Discussion Draft seeks to address these.
► Proposed changes to be considered for inclusion in next update to OECD Model.

OECD Report on Attribution of Profits to PE 2010

OECD Discussion Drafts on interpretation and application of Art. 5 (2011 and 2012)

OECD BEPS Report and Action Plans

Case law developments

The PE concept

“Key pressure areas” of BEPS include application of treaty concepts to profits derived from the delivery of digital goods and services.
► Action 1 aims to address the tax challenges of the digital economy.
► Action 7 aims to make changes to the PE definition to prevent the artificial avoidance of PE status.

► Significant case law developments mainly in Europe and also India.
► Centralized models may still trigger taxable presence in local jurisdiction.
► Impact of restructuring.
Background
PE concept – OECD Model Tax Convention

► Article 7
► “Profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein.”

► Article 5(1)
► “… the term ‘permanent establishment’ means a fixed place of business through which the business of an enterprise is wholly or partly carried on”
► Article 5(4) – exemption for specific activities (e.g., storage, display or delivery of goods) and activities that are preparatory or auxiliary in nature

► Article 5(5)
► “Where a person, other than an independent agent, has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, the enterprise is deemed to have a permanent establishment in that State.”
Background
OECD BEPS context

- OECD concern about potential for companies to engage in BEPS activity by entering into “arrangements that artificially avoid the occurrence of PEs”

- Aim of Action 7
  - “Develop changes to the PE definition to prevent the artificial avoidance of PE status in relation to BEPS, including through the use of commissionaire arrangements and specific activity exemptions. Work on these issues will also address related profit attribution issues.”

- Coordination required with work on:
  - Action 4 (interest deduction)
  - Action 8 (intangibles)
  - Action 9 (risk and capital)

- Profit attribution issues also must be considered when changing PE definition
Background
Action 7 PE Discussion Draft – the story so far

- Issued on 31 October 2014
  - Views and proposals do not represent consensus views of the OECD Committee on Fiscal Affairs or its working groups.

- Affects what type of operating models?
  - Commissionaire and similar arrangements
  - Activities considered preparatory or auxiliary in nature
  - Operating models where services are rendered by separate group entities
  - Operating models which use agents that are licensed locally to sell financial products, such as insurance policies

- Profit attribution to PEs and transfer pricing
- Over 850 pages of comments received
- Public consultation held on 22 January 2015
- Revised draft expected in spring 2015
Background
Action 7 timeline

Stage 1: Drafting, discussion, consultation and publishing final deliverable

- Discussion Draft 31 Oct 2014
- Comments due 9 Jan 2014
- Public consultation 21 Jan 2015
- Expected final deliverable Sept 2015

Stage 2: Adoption by countries in one of the following ways

Changes adopted through a treaty

- Bilaterally
  - When does it come into force? Depends on the length of negotiation between both countries.

- Multilaterally
  - When does it come into force? Depends on the length of negotiation between all countries.
### Background

**Action 7 areas of focus and proposals**

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<thead>
<tr>
<th>Areas of focus</th>
<th>Significant changes</th>
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<tr>
<td><strong>1</strong> Commissionaire (and similar arrangements*)</td>
<td>Expansion of Art. 5(5) and 5(6) by lowering the threshold for finding PE and tightening independence criteria</td>
</tr>
<tr>
<td>*Current wording goes beyond commissionaire models and could impact other sales or sales support arrangements</td>
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<tr>
<td><strong>2</strong> Specific activities exemptions</td>
<td>Narrowing scope of PE exemptions in Art. 5(4)</td>
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<td><strong>3</strong> Projects where services are carried out by several entities</td>
<td>Aggregation of time spent on same projects or application of general anti-abuse rules</td>
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<td><strong>4</strong> Insurance agents</td>
<td>Creation of deemed PE</td>
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</table>
2. Commissionaire and similar arrangements
Commissionaire and similar arrangements
What is the OECD’s concern?

What is it?
Commissionaire is a commercial structure in European civil law jurisdictions.

How does it work?
Commissionaire acts in “its own name” but for the account of a principal for the sale of principal’s goods to customers. Commissionaires do not take title for the goods sold.

What is the OECD’s concern?
Lack of taxable PE nexus means that profits from sales in State Y are taxed where the principal is resident, i.e., State X, while commissionaire is taxed on the difference between the commission fee received and its expenses in State Y.
Commissionaire and similar arrangements
Different interpretations of PE definition

- Rising trend in PE litigation in recent years and, with it, an increasing number of countries taking a very broad interpretation and aggressive approach when determining if a PE exists.

- “Substance-over-form” functional approach vs “strict application of commissionaire law”
  - Court decisions not finding an agency PE
    - France: Conseil d’État, Zimmer Case 304715 and 308525, 31 March 2010
    - Norway: Høyesterett, Dell Products v. Tax East, 2 December 2011
    - Italy: Corte di Cassazione, Boston Scientific Case 3769, 9 March 2012
  - Court decisions finding a PE using a broad functional approach
    - Spain: Tribunal Supremo, Roche Case 1626/2008, 12 January 2012
    - Spain: Tribunal Supremo, Borax Europe Ltd. Case 1933/2011, 18 June 2014
### Commissionaire and similar arrangements

#### PE case law

<table>
<thead>
<tr>
<th>Case</th>
<th>Country</th>
<th>Description</th>
<th>Decision</th>
</tr>
</thead>
<tbody>
<tr>
<td>Roche</td>
<td>Spain, 2012</td>
<td>Roche implemented a change to its business model in Spain. Having previously acted as a full-fledged manufacturer in Spain, it subsequently contract-manufactured for Swiss Co. and, at the same time, promoted the sale of Swiss Co.’s products in Spain.</td>
<td><strong>Yes PE:</strong> No authority for Spanish Co. to bind the Swiss Co. but Spanish Supreme Court reached the conclusion that there was a PE in Spain by combining the PE tests in the fixed place of business and dependent agent clauses. The Spanish High Court went through the factual circumstances of the case, and considered Spain Co. lacked independence because it operated exclusively for Swiss Co. and bore practically no entrepreneurial risk.</td>
</tr>
</tbody>
</table>
| Borax | Spain, 2011 | Borax implemented a change to its business model in Spain. Spanish Co. changed the nature of its activity from “manufacturer” and seller to a services entity, processing, transporting, storing, administration, etc., on behalf of UK Co., which was the owner of the products manufactured and marketed. | **Yes PE:** Spanish High Court found no apparent substantial change in Spanish Co.’s size and functionality upon transition to the new role. Court considered that a comprehensive analysis of the structure and the behavior of the parties as a whole supported the conclusion that a “complex business set up” in Spain was “at the disposal” of British Co. because the analysis showed:  
► That a substantial part of functions assumed by Spanish Co. related to distribution role  
► There was no clear separation of functions and resources between the related entities  
► Spanish Co.’s Human Resources was at British Co.’s disposal |
## Commissionaire and similar arrangements

### PE case law

<table>
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<th>Description</th>
<th>Decision</th>
</tr>
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<tbody>
<tr>
<td>Zimmer</td>
<td>France, 2010</td>
<td>Zimmer SAS acted as a commissionaire for Zimmer Ltd. Zimmer SAS could accept orders, present estimates and offers, and conclude contracts for the account of its UK principal but acted in its own name and could not legally conclude contracts in the name of the principal.  No PE: Supreme Court held French Co. could not be a PE of UK Co. because it could not legally bind UK Co. as principal. It considered irrelevant the tax authorities’ and lower courts’ opinions that French Co. had the ability to bind the UK principal in a “commercial relationship.”</td>
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<tr>
<td>Dell</td>
<td>Norway, 2011</td>
<td>Dell AS sells goods in its own name but at the risk of Dell Products Ltd., resident in Ireland. Tax authorities claimed Dell AS formed a PE. Key question was whether Art. 5(5) should be interpreted such that it was a requirement that the principal had to be legally bound or was it enough that the agreements entered into were “in reality” (i.e., factually) binding.  No PE: Contracts concluded by Dell Norway were not legally binding on Dell Ireland. The Norwegian Supreme Court indicates that for a representative to constitute a PE for the principal, the contracts entered into by the representative must be legally binding on the principal (reference to Zimmer).</td>
<td></td>
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<tr>
<td>Boston Scientific</td>
<td>Italy, 2012</td>
<td>Italian subsidiary acted as a commissionaire of a Dutch principal. Italian subsidiary was 99% controlled by principal and worked exclusively for its parent.  No PE: Supreme Court ruled that the Italian Co. did not constitute a PE of the Dutch Co. due to its operational autonomy and the business risks borne. Subsidiary control and exclusivity not significant elements per se to create a PE.</td>
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</table>
Commissionaire and similar arrangements
OECD proposed changes

- OECD proposed several options to lower the threshold for creating a PE taxable nexus.
- The options widen the type of activity that can give rise to a PE as follows:

  - Art. 5(5) “Conclude contracts”
    - Engages with specific persons in a way that results in the conclusion of contracts
    - Concludes contracts, or negotiates the material elements of contracts

- Focus is on the object of the contract as well as involvement of the intermediary in the conclusion of contracts.

- **Result:** Enterprise will now have PE if the intermediary’s activities result in a conclusion of contract or if they negotiate material elements of a contract.

  **Before**
  Actual conclusion of contracts was required to create a PE.

  **After**
  Actual conclusion of contracts **not** required. Mere participation with specific persons in a way that results in the conclusion of contracts, e.g., negotiating “material elements” of contracts on behalf of a principal, could create a PE.
Commissionaire and similar arrangements
OECD proposed changes

- New focus on the legal relationship between the intermediary and foreign enterprise

**Art. 5(5) “Contracts in the name of the enterprise”**

- **Result:** Enterprise would have a PE if the intermediary concludes contracts, or negotiates “material elements” of a contract which, although not in the name of the enterprise, are on the account and risk of the enterprise.

**Before**
Contracts in the name of the enterprise.

**After**
Concluding or negotiating material elements of contracts on the account and risk of the enterprise could create a PE.
Commissionaire and similar arrangements
OECD proposed changes

► All proposed options will modify the independence requirement in Art. 5(6)

Art. 5(6)

► Result: Agent that acts exclusively or almost exclusively for associated enterprise(s) is not independent.

Before
Depending on the facts and circumstances, agent acting on behalf of just one enterprise could be considered independent.

After
Agent who acts exclusively or almost exclusively on behalf of one enterprise or associated enterprises* is a dependent agent.

*Enterprise is associated if it participates directly or indirectly in management, control or capital of other enterprise, or same persons participate directly or indirectly in management, control or capital of both enterprises.

Art. 5(5) conditions to be specifically subject to independence test in Art. 5(6)
Delete explicit examples of agents of independent status: “broker and general commission agent”
Adds a new requirement for determining independence: nonexclusivity of clients
Insertion of enlarged concept of “associated enterprises”
## Commissionaire and similar arrangements
### Overview of impact should the proposals be adopted

<table>
<thead>
<tr>
<th>Question</th>
<th>Answer</th>
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</table>
| **What is the PE risk?** | Operating models where commissionaire or sales intermediary is involved in activities that lead to the conclusion of a contract may give rise to a PE.  
  - It will no longer matter that the contract is not in the name of the principal, as long as the contract is effectively on the account and risk of the principal.  
  - Operating models using exclusive (or almost exclusive) agents would now be considered to create PEs. |
| **How real is this risk?** | Consider the trend – many countries are using the OECD proposals to justify their aggressive approach in finding PEs. |
| **What is the taxable impact if PE exists?** | If a PE exists, it would be necessary to determine what profits are attributable thereto. Accordingly, an analysis of potential taxable impact in the following areas is required:  
  - Potential for double taxation  
  - Direct and indirect tax compliance and registration obligations and associated costs  
  - Human capital taxation liability issues and associated costs  
  - Review of existing transfer pricing and profit attribution basis |
3. Use of specific activity exemptions
Specific activity exemptions
What is the OECD’s concern?

► Art. 5(4) of the OECD Model Tax Convention allows an entity from state X to undertake specific exempted preparatory or auxiliary activities in state Y without creating a PE in state Y.

► Why? Preparatory or auxiliary activities were generally considered non-value-adding activities and therefore little profit would be allocated thereto.

► What is the OECD’s concern?
  ► Specific activity exemptions open to BEPS abuse.
  ► Activities performed in state Y may, in fact, be value-added for the taxpayer’s business.
    ► Delivery of goods
    ► Purchasing of goods or collecting information
    ► Fragmentation of business activities
  ► Profits that should be taxed in state Y are instead taxed in state X where the taxpayer is resident.
Specific activity exemptions
OECD-proposed changes

The OECD proposed several options to modify Art. 5(4), which affect the following areas:

- Exemptions are restricted to preparatory or auxiliary activities
- Delete the word “delivery”
- Delete exemption for purchasing goods or collecting information
- Expand anti-fragmentation rule to associated enterprises
Specific activity exemptions
OECD-proposed changes – *preparatory or auxiliary*

- The OECD proposed wording to narrow the range of specific exempted activities.
- First option – all activities in Art. 5(4) should be subject to preparatory or auxiliary condition.

**Before**

Wording did not require all activities to be preparatory or auxiliary.

**After**

All exemptions restricted to preparatory or auxiliary activities only.

- What this means:

**Before**

For example, warehouse facilities used for delivery of goods were exempted.

**After**

Warehouse facilities used for delivery of goods will be exempted, **only** if the activities performed also meet the overriding preparatory or auxiliary test; otherwise, there is a PE risk.

- If the first option is not adopted, the OECD proposed three other options targeted at specific exemptions on which the OECD has BEPS concerns.
Specific activity exemptions
OECD-proposed changes – delivery

► Second option – delete the word “delivery” in Art. 5(4)(a) and (b)

Before
PE exemptions for:
  a) The use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise
  b) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery

After
If the word “delivery” is deleted from the exemption:

The use of any facilities for the delivery of goods would give rise to a PE for the foreign enterprise in the warehousing country.

► Interestingly, the OECD cites UN Model Commentary, which notes that even if the delivery of goods could give rise to a PE, the amount of profit attributable may not be significant.
Specific activity exemptions
OECD-proposed changes – *purchasing*

Third option
- Retain exemption for collecting information but delete the reference to purchasing activities in Art. 5(4)(d)
  - Or
  - Delete the entire paragraph d)

**Before**
PE exemption for:
d) The maintenance of a fixed place of business solely for the purpose of purchasing goods, or merchandise, or of collecting information, for the enterprise

**After**
If reference to purchasing is deleted:
Offices used for collecting information would be exempted, though offices used for purchasing activities could create PEs.

If entire paragraph d) is deleted:
Offices used for collecting information and/or purchasing activities could create PEs.
Specific activity exemptions
OECD-proposed changes – fragmentation of activities

Fourth option

- Extend the anti-fragmentation rule to cover activities of associated enterprises
  Or
- Extend the rule to cover situations where the combined activities at the same place or different places exceed what is preparatory or auxiliary

Before
Existing anti-fragmentation rule covers only activities undertaken by one enterprise.
The maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character

After
If either alternative of the above is adopted:
Enterprises which have activities carried out by a group of associated/related entities at the same or different locations may now create a PE risk if they are performing “complementary business activities as part of a cohesive business operation” and that such activities, when combined, exceed what is preparatory or auxiliary.
## Specific activity exemptions

### Overview of impact should the proposals be adopted

<table>
<thead>
<tr>
<th>What is the PE risk?</th>
<th>Activities which used to fall under any of the existing specific activity exemptions may now give rise to PE risk unless it can be shown that these activities are, as a whole, preparatory or auxiliary.</th>
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<tbody>
<tr>
<td></td>
<td>Facilities used for the following activities could now give rise to a PE:</td>
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<tr>
<td></td>
<td>▶ Delivery</td>
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<td></td>
<td>▶ Purchasing and/or collecting of information</td>
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<td></td>
<td>Operating models which involve various group entities performing “complementary business activities as part of a cohesive business operation” may give rise to a PE if these activities, when viewed as a combined whole, exceed what is considered to be preparatory or auxiliary.</td>
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<tr>
<th>How real is this risk?</th>
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<td>▶ Review of existing transfer pricing and profit attribution</td>
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</table>
4. Profit attribution and transfer pricing
Profit attribution and transfer pricing
What are the issues?

Current OECD discussion points around Action Item 7 and profit attribution

- What amount of profit should be attributed to a PE if the PE definition were to be changed?
- Does this profit justify the additional compliance burden due to the expected widening of the PE definition in Art. 5?
- Specifically: What profit should be attributed to a dependent agent PE?
- Could some of the perceived BEPS issues be dealt with through the sound application of transfer pricing principles, rather than the proposed changes to the PE definition?
- How will the “force of attraction” principle be dealt with according to OECD and UN Models in the future?
Profit attribution and transfer pricing
Authorised OECD Approach (AOA)

- Profit attribution to a PE according to the AOA
  - Functionally separate entity approach
  - Implemented in Art. 7 OECD-MTC, commentary and 2010 OECD Report on the attribution of profits
  - Application of the arm’s-length principle also for transactions between the PE and the head office
  - Two-step approach for the determination of the profit attributable to a PE

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**Step 1**
**Functional and factual analysis**
(PE to be treated as if it is a separate and independent enterprise)

**Step 2**
Determination of the profits based on a **comparability analysis**
### Profit attribution and transfer pricing

**Application of the AOA – Step 1**

#### Functional and factual analysis

<table>
<thead>
<tr>
<th>Attribution of risks</th>
<th>Attribution of assets</th>
<th>Attribution of free capital</th>
<th>Identification of dealings</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Significant people functions</td>
<td>- Economic ownership test</td>
<td>- Requirement of sufficient capital in PE to support:</td>
<td>- Dealings recognized under the AOA</td>
</tr>
<tr>
<td>- Initial acceptance of risks</td>
<td>- Tangible assets</td>
<td>- The functions performed</td>
<td>- But threshold needs to be passed</td>
</tr>
<tr>
<td>- Subsequent management of risks</td>
<td>- Based on usage</td>
<td>- The assets economically owned</td>
<td>- Starting point: accounting records and internal documentation</td>
</tr>
<tr>
<td>- Examples:</td>
<td>- Intangible assets</td>
<td>- The risks assumed</td>
<td>- Must relate to real and identifiable event</td>
</tr>
<tr>
<td>- Inventory risk</td>
<td>- Competence to make decisions</td>
<td>- Two-step approach</td>
<td>- Problem: identification of contractual terms</td>
</tr>
<tr>
<td>- Credit risk</td>
<td>- Bearing the associated risk</td>
<td>- Quantify capital (also risks – if reliably possible)</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>- Allocation of capital</td>
<td></td>
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</tbody>
</table>

**Identification of dealings**

- Dealings recognized under the AOA
- But threshold needs to be passed
  - Starting point: accounting records and internal documentation
- Must relate to real and identifiable event
- Problem: identification of contractual terms
Profit attribution and transfer pricing
Application of the AOA – Step 2

Profit attribution

- Treatment of PE as a separate, independent entity
- Selection of the most appropriate transfer pricing method
- Attribution of profit components based on comparability analysis

Based on OECD Transfer Pricing Guidelines
**Profit attribution and transfer pricing**

Ongoing debate – profit of a dependent agent PE

<table>
<thead>
<tr>
<th>Profit attributable to a dependent agent PE of the head office</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>AOA approach</strong></td>
<td><strong>Single taxpayer approach</strong></td>
</tr>
<tr>
<td>► Contends that <em>in all circumstances</em> the profits attributable to the dependent agent PE of the head office need to be determined by an analysis of the <strong>significant people functions and the attributable risks and assets</strong> (functional and factual analysis)</td>
<td>► Contends that <em>in all circumstances</em> the payment of an arm’s-length reward to the dependent agent enterprise fully extinguishes the profits attributable to the dependent agent PE of the head office</td>
</tr>
<tr>
<td><strong>Accepted by the OECD</strong></td>
<td><strong>Not accepted by the OECD</strong></td>
</tr>
<tr>
<td>→ Both approaches may result in the same or materially similar attributable profit depending on facts and circumstances</td>
<td></td>
</tr>
<tr>
<td>→ Does this result justify the additional compliance burden?</td>
<td></td>
</tr>
</tbody>
</table>
Profit attribution and transfer pricing
Ongoing debate – “force of attraction”

What is the “force of attraction” principle?
► Basically, when X Co. from country A has a PE in country B, it brings itself within the fiscal jurisdiction of country B such that country B can now tax all profits that X Co. derives from that country, whether through the PE or not.
► That is, the mere existence of PE in country B may lead to all profits derived from country B being treated as taxable by country B.

UN Model advocates “limited force of attraction” principle in Article 7.
► Only profits from direct transactions entered into by X Co. are taxed, provided the transactions are of the same or similar kind as those entered into by X Co.’s PE.

► “… the right to tax does not extend to profits that the enterprise may derive from that State otherwise than through the permanent establishment.”
► “There is no force of attraction element in the authorized OECD approach – we cannot say that just because an enterprise has a PE in a country, the PE will have the risks and rewards of all activities carried out there.”
Profit attribution and transfer pricing
Avoid key pitfalls

► Be aware of a tendency of certain tax administrations to argue for a PE rather than applying sound transfer pricing principles
► Be aware of potential issues for double taxation (e.g., applicable domestic law/double tax treaty or deviating from domestic interpretations)
► Be aware of “unintended” PEs
  ► People functions are key!
  ► In such cases, asset allocation rules according to the AOA may trigger unintended cross-border transfers.
  ► In practice, discussing internal PE Guidelines with your operations and human resource teams may help mitigate tax risks significantly.
► Be aware of the current OECD discussion items around Action 7 and transfer pricing principles, and ongoing BEPS developments
5. What should you do next?
What should you do next?
If a PE exists, you could face the following issues

1. Potential reporting and transactional mapping errors
2. Accounting, billing, reporting processes may need adjusting
3. Enterprise resource planning (ERP) systems may need reconfiguring

1. Obligation to register the PE for value-added tax (VAT)
2. Obligation to file tax returns/wage tax
3. Under declaration and payment of income tax and/or VAT
4. Risk of double taxation
5. (Mis)allocation of profits to PE
6. Potential withholding tax
7. Retroactive VAT/transfer pricing income adjustments
8. Additional interest and penalties
9. May not be chargeable to the customer and become a cost

1. Potential criminal offense for failure to report or register PE
2. Reputational risk arising from media coverage
What should you do next?
How to be Action 7 ready

Assess

► Do a “sustainability check” of your existing operating model for PE risk
  ► Coordinate your approach: consider direct tax, indirect tax, transfer pricing and human capital implications
► Consider whether there are any deviations from originally implemented model
  ► For example, where assets, capital or other liabilities deviate from prior allocations, or functions go beyond original function profile
► Consider the material impact by quantifying costs of the following risks:
  ► Direct tax
  ► Indirect tax
  ► Operational
  ► Compliance
  ► Regulatory
  ► Reputational risk

Quantify
What should you do next?
How to be Action 7 ready

Weigh

- Consider available options – feasibility analyses
- Depending on outcome of weigh and feasibility analyses:
  - Reinforce existing structure (defense file). Creation of PE does not automatically mean there will be additional profit that is taxable
  - Or
- Change the structure
- Consider being proactive (e.g., advance pricing agreement (APA))

Quantify
What should you do next?
How to be Action 7 ready

- Prepare detailed guidelines for the business for relevant operating models
- Monitor compliance with these guidelines for operating models on a regular basis
  - Review functional activities
  - Review transfer pricing for these activities
  - Review international travel and relocation of personnel (including numbers of employees, duration of temporary assignments and other aspects of expatriate assignments)
- Oversight by internal audit
Controversy: Customs
Customs implications of transfer pricing approaches for intangibles and services
Agenda

► Objectives

► Intercompany payment flows for intangibles and services – implications for customs

► Summary
Objectives
Objectives

► Discuss the intersection of transfer pricing and customs valuation – specifically focus on areas “other than” sales of tangible products

► Identify opportunities to avoid negative customs impact with respect to certain intercompany payments for intangibles and services

► Identify opportunities to enhance duty savings
Intercompany payment flows for intangibles and services – implications for customs
Comparing and harmonizing transfer pricing principles and customs valuation

► Most countries use World Trade Organization (WTO) valuation rules, or have valuation laws based on WTO rules.

► Most customs duties are assessed ad valorem, and are often based on a combination of:
  ► Product sale prices
  ► Other payment flows for tangible or intangible goods or services to the extent they can be tied to imported products

► Customs authorities are concerned with capturing/reporting both tangible and “tied” intangible values.
Customs valuation methods

  - Transaction value (based on the sale price), plus statutorily required additions
  - Transaction value of identical or similar merchandise
  - Deductive value (resale minus)
  - Computed value (cost plus)
  - Fallback method (catch-all)
**Customs “base” – transaction value**

**Transaction value**

- Price paid or payable for goods when sold for export
- Plus certain required additions

The following, to the extent incurred by buyer but not included in price of goods:

- Costs ~ related to production, sales, packaging, transport
- Commissions and brokerage (except buying)
- Packaging and transportation
- Plus other considerations
- Royalties and license fees
- Proceeds of subsequent resale

Assists – certain goods/services supplied by buyer free or at reduced charge for use in production or sale for export:
- Tangible (e.g., materials, components, tools, molds)
- Services undertaken outside import country (engineering, design)
International tax trends
Evolution of procurement/sourcing function in the value chain

► A variety of intangible rights and services can fall within the customs “additions to value” – particularly when considering the evolution of procurement companies in supply chain.
► Traditional procurement is focused on demand aggregation and driving cost savings for the broader organization through volume discounts.
► New procurement function is focused on aligning with strategic suppliers.
► It’s increasingly more important to partner with suppliers that will be catalysts for future growth – e.g., suppliers with whom they can partner to co-develop innovation that translates into revenue growth for the organization.
► In new procurement function, cost reductions are driven by optimizing supplier’s processes to drive cost out of entire system, rather than relying on negotiation tactics.
► Cost optimization is generally driven by engineering changes to the process and investment from the company’s perspective.
► In certain industries, supplier management also involves risk management.
International tax trends
Evolution of procurement/sourcing function in the value chain

Traditional sourcing company

- Develops and executes procurement/sourcing strategy for raw materials (including commodity products)
- Aggregates demand and negotiates price reductions
- Negotiates contract terms based on cost improvement initiatives, e.g., investment by supplier in technology or processes to lower costs

External partnership sourcing company

- Defines overall procurement/sourcing strategy for business
- Manages end-to-end supply chain for finished goods, including sales and operations planning process
- Partners with suppliers to develop cost improvement initiatives, including process know-how and innovation
- Responsible for product quality, including product liability risk
- Establishes and tracks key metrics for suppliers
- Assumes risks related to inventory (reliability of forecast), insurance and other economic risks
## Trends in services performed
(Examples related to substantial contribution to manufacturing under US tax rules)

<table>
<thead>
<tr>
<th>Indicia of manufacturing</th>
<th>Examples of activities</th>
</tr>
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| 1. Oversight and direction of the activities or process under which the product is manufactured | ► Supply and demand planning  
► Oversight of manufacturing and process controls  
► Drive partner development to improve capabilities and performance (quality, delivery, cost, risk reduction)  
► Formulate policy to focus on strategic |
| 2. Activities considered in, but insufficient to satisfy, the substantial transformation | ► Fill and finish |
| 3. Material selection, vendor selection, or control of raw materials, work-in-process or finished goods | ► Qualify, select and manage contract manufacturers – participate in make/buy decision  
► Manage supplier risk (capacity, obsolescence)  
► Determine supplier capacity and continuity |
| 4. Management manufacturing costs or capacities | ► Identify and manage cost improvement initiatives (e.g., lean manufacturing, Six Sigma)  
► Manage cost initiatives (e.g., inventory reduction, price reduction) |
## Trends in services performed
(Examples related to substantial contribution to manufacturing under US tax rules)

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</table>
| 5. Control of manufacturing-related logistics                                               | ► Direct planning and production schedules for external partners  
► Monitor production orders, schedules and output so that products are manufactured and scheduled delivery dates are met |
| 6. Quality control                                                                         | ► Evaluate supplier quality systems and share best practices  
► Negotiate quality agreements  
► Undertake quality audits                                                                  |
| 7. Developing, or directing use or development of product design and design specifications, as well as trade secrets, technology or other intellectual property (IP) for purpose of manufacturing or producing product | ► Develop technology transfer process for new product introductions  
► Transition design or process changes to external partners  
► Partner with suppliers on supply chain development initiatives |
Case study
Intercompany payments for services, intangibles

HK SourceCo. (HK)

Related manufacturers

License Agreements

Royalty payment based on % of net resale (product IP - know-how, trademark, sales and marketing IP)

Purchase agreements for goods

Unrelated manufacturers

Charges for molds, tools produced or acquired by manufacturers

HK Trading (HK)

Support Services Agreement

Service fee based on cost plus (back-office, raw material procurement, manufacturing support, transportation)

Sourcing company

Buying Agency Agreement

Commission based on % of free on board (FOB) (qualify/select vendors, negotiation, procurement, quality control (QC), design)

Purchase Agreements

License Agreements

Service Provider

SourceCo. (HK)

Local country distributors

Customer

Sales

Unrelated manufacturers

Related manufacturers

(Licensor)

(related manufacturers)
Transaction value
Additions to price paid or payable – assists

“Assists” – any of the following types of production assistance which buyer provides, directly or indirectly, and free of charge or at reduced cost for use in the production of the goods for export:

- Materials, components, parts and similar items incorporated in the imported goods
- Tools, dies, molds and similar items
- Merchandise consumed in producing the imported goods
- Engineering, development, artwork, design work, and plans and sketches undertaken in a foreign country
  - “How to make” versus “what to make”
  - Multi-country research and development (R&D) may be an assist in one country but not another

Value of assist – cost of acquiring if from unrelated party, or cost of producing if by importer or related party

- Includes the cost of transportation and related charges to the production location

For services – can be effective to identify people performing activities determined dutiable; use corresponding costs as basis for valuing assist (even where services compensated on a basis other than cost plus)
Buy-sell model – Case study
Involving intercompany payments for services, intangibles

- Not likely dutiable buying commission
- Likely an assist – design work *undertaken in foreign country* which buyer indirectly provides free for use in production
- Value of assist – cost of acquiring if from unrelated party, or cost of producing if from importer or related party
  - Includes cost of transportation to production location
- For services – can be effective to identify people performing activities determined dutiable; use corresponding costs as basis to value assist (even where compensation is other than cost plus)
Transaction value – other payments

► If there are additional payments of any sort between buyer and seller, consider whether they are really part of price paid or payable.

► Any payment to a seller, direct or indirect, can be an extra part of price even if not one of the five categories of “additions to the price paid or payable.”

► As a “golden rule,” if price of imported merchandise would have been higher if secondary payment had not been made, then customs is more likely to treat second payment as hidden part of price paid or payable.
Buy-sell model – Case study 1
Involving intercompany payments for services, intangibles

- Not likely dutiable buying commission
- Likely an assist – design work undertaken in foreign country which buyer indirectly provides free for use in production
- Value of assist – cost of acquiring if from unrelated party, or cost of producing if from importer or related party
  - Includes cost of transportation to production location
- For services – can be effective to identify people performing activities determined dutiable; use corresponding costs as basis to value assist (even where compensation is other than cost plus)
Buy-sell model – Case study 2
Involving intercompany payments for services, intangibles

► Some services likely not dutiable; others likely dutiable as assist
► Back office functions likely non-dutiable (e.g., order administration, finance)
► Manufacturing production assistance more complex to determine
► Quality control at end of production line on finished product – likely not dutiable
► Quality control of production lines – likely dutiable (e.g., calibrating machines and adjusting technical specifications)
► Transportation management for finished goods – not dutiable; for raw materials – likely dutiable
► Highlights the importance of contracts, accounting records and documentation
Buy-sell model – Case study 3
Involving intercompany payments for services, intangibles

- Manner in which service provider compensated can implicate other “customs additions to value”
- Consider proceeds of subsequent resale

HK SourceCo. (HK)
- Support Services Agreement
  - Service fee based on % of net proceeds of resale (back-office, raw material procurement, manufacturing support, transportation)

Related manufacturers

Sourcing company

Purchase Agreements for goods

Local country distributors

Purchase Agreements
Transaction value
Proceeds of subsequent resale

- The value of any part of the proceeds of any subsequent resale, disposal or use of imported goods that accrues directly or indirectly to the seller

- Many countries apply “proceeds” concept broadly
  - Example, Canada – Memo D13-4-13 – Post-Importation Payments or Fees
    - “Subsequent proceeds” – “must” examine several kinds of post-import payments
      - Any payments based on resale of goods that cannot be related by importer to services received
      - Management or administration fees
      - Contributions to research and development
      - Contributions for worldwide marketing or promotion
      - Overhead expenses related to manufacturing but not captured in selling price and recovered after import
      - Interest on deferred payments
      - Other payments made after importation
Royalties – WTO Valuation Agreement Article 8.1(c) – royalty and license fees related to imported goods which must be paid as condition of sale are dutiable.

World Customs Organization (WCO) – Technical Committee on Customs Valuation – Commentary 25-1 (2011) – guidance where royalty paid to third-party licensor (even where unrelated to seller) confirms broad concept that “control” over purchasing environment can create a practical condition of sale.
Planning opportunity
Exclusive distribution (EDR) and demand creation rights

US ruling HQ H242894 obtained by Ernst & Young LLP

Current model

Manufacturer | US distributor | US Customs (using 2.5% vehicle rate) | US Customs (using 2.5% vehicle rate) | US distributor

$5 billion | $125 million | $6.25 million annual savings in US duty

Model with EDR (5% of value separated)

Manufacturer | US distributor

$4.75 billion | $118.75 million

EDR fee $150 million USD

$125 million

Global application

WCO Technical Committee on Customs Valuation currently reviewing
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