Eight for 2018 and beyond: Key transfer pricing risks in the post-BEPS world

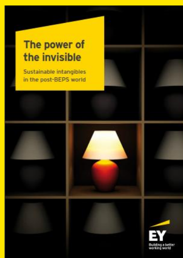
Edition 1: The sale and transfer of intellectual property assets

July 2018

EY

Building a better working world

Extend your information reach



Sustainable intangibles in the post-BEPS world

Intangible assets are playing an increased role in business success and, as a result, in the taxation of profits. But as the who, where and how for intangible management changes, so does the approach of tax authorities in allocating intangibles' returns.

In this EY report, we discuss the evolution in the role and management of intangibles from a business and operational perspective, and how the BEPS changes in the transfer pricing treatment of intangibles respond to these business developments, creating new risks for business.

go.ey.com/2JTKZLL.

EY Americas

David Canale
EY National Tax Services, EY Global Transfer Pricing Controversy Leader
david.canale@ey.com

Tracee J. Fultz
EY Americas Transfer Pricing Controversy Leader
tracee.fultz@ey.com

Michael McDonald
EY National Tax Services, International Tax Services – Transfer Pricing
michael.mcdonald4@ey.com

Jost Funke
Senior Manager, International Tax Services – Transfer Pricing
jost.funke@ey.com

EY Asia-Pacific

Luis Coronado
EY Asia-Pacific Transfer Pricing Controversy Leader
luis.coronado@sg.ey.com

EY Europe, Middle East, India and Africa

Ronald van den Brekel
EY EMEIA Transfer Pricing Leader
ronald.van.den.brekel@nl.ey.com

Marlies de Ruiter
EY Global International Tax Services Policy Leader
marlies.de.ruiter@nl.ey.com

Eight for 2018 and beyond: key transfer pricing risks to consider

2017 was an eventful year for global tax reform and 2018 is shaping up to deliver much the same outcome, if not more. And with many changes already scheduled for 2019, this three-year period looks set to deliver transformation in all areas.

We will see many countries continue to implement the Base Erosion and Profit Shifting (BEPS) action items of the Organisation for Economic Co-operation and Development (OECD) at a high pace in 2018, including signing the multilateral instrument (MLI) and various tax-related exchange of information agreements. The European Union (EU) is working on several initiatives that go beyond what has been agreed upon by OECD member countries. And US tax reform has been enacted, with many countries now in the process of reacting to it.

The voice of business
Top three risk areas: Tax steps into the light - 2017-18 Tax Risk and Controversy Survey Series

1. Transfer pricing of goods and service
2. Indirect taxes – including VAT, GST and customs
3. Permanent establishment risk

It will also be marked as the year in which companies around the world really start to understand how all of these changes combine to impact their businesses and how they may need to adjust. At the same time, reform initiatives, far from abating, will continue, especially in the area of digital taxation, an area where intangibles play a strong role.

Against this backdrop of relentless and fundamental change, long-term trends continue to play out. In fact, whatever year it is, the leading cause of risk in successive EY *Tax Risk and Controversy Surveys* is perennially agreed to be transfer pricing (TP). In this article, we identify and elaborate on eight key TP risks (among others) that companies should proactively address in 2018 and beyond. We will then pick up and explore our first identified TP risk in more detail – that of the challenges of addressing the sale or transfer of intellectual property (IP) – before returning in subsequent articles to discuss the remaining topics.

Our eight for 2018

1. IP-related developments

There are several developments that will affect the taxation of IP and IP structures in 2018, regardless of whether the IP is transferred, sold, licensed or co-owned through cost sharing arrangements.

Arguably, the two most important developments are first, US tax reform (and potential responses by other countries), and second, the ongoing discussions at OECD level after changes to Chapter I and VI of the OECD TP Guidelines for Multinational Enterprises and Tax Administrations 2017 (OECD Guidelines).[1] In this second area, the concepts of DEMPE (development, enhancement, maintenance, protection, and exploitation) functions and Hard-To-Value Intangibles (HTVI) are particularly complex.

2. High-value services transactions

Closely linked to the issue of IP transfers are the TP aspects of high-value service transactions. Examples of high-value services are strategic and c-suite services, technical services that create or contribute to the development of IP, and services with embedded IP. In certain cases, the distinction between IP and high-value services is hard to draw, in turn raising questions of how such a transaction should be characterized for tax purposes and how it should be priced.

3. Headquarter and management services transactions

Many multinational companies (MNCs) provide centralized headquarter management services for the benefit of their entire group. Examples of such centralized management services are corporate strategy, treasury, financial planning and analysis, M&A, accounting, HR and IT, among others.

Tax authorities in the MNC's headquarters location expect taxpayers to charge out all costs related to services that benefited foreign-related service recipients and will deny deductions of costs that were not incurred to the benefit of the local taxpayer. A challenge arises from the fact that some tax authorities in the country of the service recipient do not allow a deduction for tax purposes of these charges, arguing that the services were either not beneficial, duplicative, higher than what it would have cost the

Headquarter and management services transactions (continued)

local taxpayer if it had obtained those services from a local service provider, or because they object to how costs have been allocated. This situation is sometimes referred to as "stranded cost."

While the new Section D of the revised Chapter VII of the OECD Guidelines provides for an elective, simplified approach for certain low-value adding services in order to avoid this stranded cost problem, it does not resolve the issue for high-value services that might be centrally provided, such as R&D, sales and marketing, and corporate senior management services.

Companies should expect continued scrutiny of high-value intercompany headquarter and management services charges in 2018.

4. Intercompany financing transactions

In the last few years, tax authorities have focused more and more attention on intercompany financing transactions, especially within non-financial services organizations.

Nowhere has this been better illustrated than in the so-called "Chevron case," where the decision shows that TP disputes do not just involve an evaluation of the pricing of related party arrangements, but a wider, more thorough analysis of the nature of the property involved in order to determine precisely what needs to be priced. This involves consideration of complex contractual questions and evidentiary issues.

Tax and finance departments are often well-positioned to know what intragroup loans are in place, but pricing these loans for tax purposes requires more than just knowledge of current interest rates. Negotiating the world of option adjustments, "halo" effects and debt-capacity analysis may not be a possibility for less well-resourced or experienced tax functions.

Guarantees on commercial transactions, on the other hand, can often be put in place without a tax department's knowledge, and can have significant repercussions during a tax audit. Once detected, guarantees can be some of the most difficult transactions to price. Cash pooling, factoring and other risk transfer transactions are likewise increasingly under scrutiny.

[1] *OECD releases 2017 Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, EY, 14 July 2017. ey.com/gl/en/services/tax/international-tax/alert--oecd-releases-2017-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations.

Intercompany financing transactions (continued)

An informed approach to these types of transactions can underpin a company's broader tax strategy.

With the Chevron case decided in favor of the Australian Taxation Office (ATO), MNCs should be aware of the fact that material intercompany financial transactions entered into by non-financial companies is set to become a key focus area of tax authorities not just in Australia, but around the world.

5. Procurement structures

Procurement has evolved into a key function for many MNCs, and it is increasingly involved in strategically driving long-term cost leadership and delivering a cost footprint that supports the MNC's financial performance, value proposition and positioning in its competitive environment.

From a tax perspective, the broader role of procurement personnel for many MNCs has attracted the focus of tax authorities.

Many countries are now seeking to expand the PE concept, as well as more carefully scrutinizing how synergies are allocated within a group, out of concern for abuse by MNCs.

Tax authorities are particularly concerned that foreign enterprises are performing substantial value-adding activities in their countries; the country, however, cannot tax those in-country activities because the company's physical presence falls outside the traditional PE concept as defined in double tax treaties.

The MLI formalizes the BEPS Action 7 recommendations and collectively updates much of the world's double tax treaty network to reflect those recommendations, including expanded concepts of the traditional PE types: fixed place PE, construction PE, agency PE and service PE.

Procurement structures and permanent establishment risk (continued)

As businesses have leveraged procurement into an expanded role, countries have also become more likely to view the procurement function as a value-adding activity. The MLI and BEPS Action 7 have similarly recognized this in seeking both to broaden PE definitions and also to narrow certain PE exclusions that typically applied to procurement models.

With MLI-led changes now occurring and many countries separately updating their domestic PE rules in line with BEPS Action 7, MNCs should expect new efforts and inquiries by tax authorities to identify PEs. This means greater risk of tax controversy and potentially additional tax liabilities or tax compliance issues.

The most significant change relates to the blanket exclusion for purchasing activities contained in many bilateral tax treaties, which under the MLI will be narrowed to "preparatory or auxiliary" purchasing activities only.

Procurement functions that rise above the preparatory or auxiliary threshold are therefore at a greater risk of triggering a fixed place PE, when performed through a local office, or triggering an agency PE, when performed through agents or employees present in source markets.

The OECD commentary provides some guidance – e.g., that a preparatory or auxiliary activity should not be an "essential and significant" part of activity as a whole – but ultimately the determination will be highly fact-intensive and specific to the specific business. Companies will have to reflect on their core business and competitive advantages, deciding whether procurement is a value driver.

6. Limited-risk entity structures

Many companies' supply chains involve entities that perform limited functions, own few assets and/or do not bear significant risks. If such an entity performs manufacturing activities, it is referred to as a contract or toll manufacturer If it performs distribution functions, it is known as a Limited Risk Distributor (LRD).

All of these entities are now being challenged by tax authorities with respect to the limited risk nature of their activities and the low profits associated therein. Tax authorities are arguing, for example, that a company that is being characterized as bearing limited risks "on paper," (i.e., as per an agreement between the limited risk entity and a related-party principal) in actuality bears significantly more risks and performs more functions than may be stated in the agreement. Examples of criticism expressed by some governments are that LRD's may actually perform significant marketing functions or that contract manufacturers may bear significant idle capacity risks.

Tax authorities may also argue that the contractual separation of functions and risks is often artificial. Additionally, some governments are trying to ensure that any IP associated with a limited-risk function is being captured in their country in terms of its ability to generate revenue, even if that IP is technically not owned by the limited-risk entity.

A further important development that has put limited-risk structures under pressure, and one that is a direct result of the BEPS initiative, is the lowering of the threshold for governments to assert that an MNC with limited-risk entities in a particular jurisdiction has an additional taxable presence through a PE (see previous section) with respect to the functions that might have formerly been performed by the limited-risk entity in that country.

Companies should therefore review their structures with respect to their limited-risk entities, ensuring that they have the appropriate functions and risks analyses are available should a structure be challenged by the tax authorities. In addition to the legally required minimum TP documentation in each jurisdiction involved, companies should have a more robust defense file available that analyzes facts in greater depth, supporting further inquiries or challenges to the structure.

7. Two-sided nature of pricing a transaction

Some MNCs have implemented supply chain structures that involve intermediaries located in a different jurisdiction from the location(s) of its manufacturers and distributors, such as regional principals who manage the supply chain and then subcontract related party manufacturers to produce products and related party LRDs to distribute them.

Two-sided nature of pricing a transaction (continued)

Such structures may have been set up during a time at which the overall system profit of the supply chain was low, and hence the profit shares of all related parties involved were commensurate with their value contributions.

From a traditional TP perspective, the parties whose profits would be measured to determine whether intercompany transactions were priced at arm's length would have been the manufacturers and the distributors (the so-called tested parties).

Following the 2015 BEPS recommendations, additional system profits that exceed the contractually agreed compensations for the tested parties may now flow to the intermediary in the absence of a profit sharing mechanism. Depending on the circumstances, the profit share of the intermediary, when compared to the tested parties and in light of its value contributions, could be viewed as excessive by some tax authorities. There is a risk, therefore, that structures similar to this may be challenged by more than one tax administration, going forward.

In the future, and with the benefit of greater visibility of an MNC's global footprint and location of profits, we expect tax authorities to increase their scrutiny of an MNC's entire system profit and how their profit is distributed around the world.

8. Limitation of deductibility of costs based on domestic rules, instead of based on TP adjustments

An emerging TP topic that companies should closely monitor relates to the limitation of deductibility of certain intercompany transactions based on domestic tax rules other than TP, i.e., a limitation of deductibility of intercompany transactions that tax administrations seemingly agree were priced at arm's-length, but where such non-deductibility is conditional on the receiver being an associated enterprise. Or, said differently, TP adjustments disguised as a domestic adjustment issue.

This is set to be a key issue in the future, mirroring the broader issue of interaction between domestic anti-abuse rules and treaty obligations.

Japan, for instance, sometimes uses a domestic "donation" argument to avoid the Mutual Agreement Procedure (MAP) included in its double tax treaties on a TP compensating adjustment. However, the US IRS and Japan's National Tax Authority (NTA) have agreed that this is a TP issue and should therefore be addressed through MAP. It remains to be seen how Japan will deal with other treaty partners on the donation issue.

Limitation of deductibility of costs based on domestic rules instead of based on TP adjustments (continued)

A further historic example of this issue is that the IRS used to use an Internal Revenue Code (IRC) § 162 (Ordinary and Necessary Business Expense) argument for TP adjustments to avoid IRC § 482 and MAP, i.e., deny a deduction in the US as not being ordinary or necessary. In these cases, the IRS Competent Authority has typically disregarded this argument and addressed such an adjustment in MAP.

A review of global IP-related developments

As the world transitions from the industrial to the digital age, IP is increasingly becoming a primary driver of business profits. Therefore, the importance of IP-related TP is also growing.

At the same time, the crucial features of IP that distinguish it from other assets is that it is highly mobile, and at times difficult to define and price when compared to other assets or services. The key issues related to IP and TP therefor tend to be:

- Identification of the asset: what is the IP subject to analysis?
- Delineation of the transaction: who owns, uses and contributes to the development of the IP?
- Valuation: what is the value of the IP?

There are multiple converging trends affecting some or all of these key issues, including US tax reform, the OECD-level debate on intangibles and the global debate on digital taxation. Furthermore, it should be noted that many differences of opinion exist between mature and emerging jurisdictions.

US tax reform related to IP

One of the most important developments regarding IP expected to impact companies' related strategies in 2018 and beyond is US tax reform, i.e., the Tax Cuts and Jobs Act (TCJA), which contains several changes related to how IP is defined and taxed from a US perspective.

Most importantly, the TCJA codifies an expansive definition of what constitutes IP, which now explicitly includes workforce in place, goodwill and going concern as IP within the meaning of Section 936(h)(3)(B).

A further important change is the introduction of the global intangible low-taxed income (GILTI), foreign-derived intangible income (FDII) and base erosion anti-abuse tax (BEAT) measures. A collective impact of these changes is that, on one hand, it makes the US a more competitive location in which to develop and own IP. On the other hand, however, it may limit the options that companies have to restructure their supply chains through outbound IP transactions.

From an IP valuation/transfer pricing perspective, the TCJA effectively codifies valuation principles long espoused by the US Treasury and the IRS. Therefore, terms such as "workforce" or "goodwill" should not be used to inappropriately justify transfers of value without compensation. However, it should not be the case that all aspects of the accounting value of goodwill, workforce, etc. are necessarily compensable. Instead, the determination of appropriate compensation will not simply turn on the classification of the contribution. Depending on the nature of the IP covered in the intercompany transaction, comparable uncontrolled transactions (CUTs) may be considered less reliable going forward. The aforementioned notwithstanding, the income method, properly implemented, is still a (potentially) appropriate method, depending on individual facts and circumstances.

Due to the expanded definition of IP, as well as the move to a semi-territorial tax regime, corporate taxpayers should expect an increased focus on TP by US tax authorities as well as from non-US tax authorities/governments as they respond to US changes.

Companies should therefore closely examine the impact that US tax reform has on their IP structures, including:

- Alignment of IP with value creation
- Ability to shift manufacturing footprint
- IP or principal company structure in US
- The location of research and development (R&D) centers

To the extent that such structures are covered by an existing advance pricing agreement (APA), companies should evaluate the implications of US tax reform.

In summary, companies need to evaluate the costs and benefits of their current IP strategy in relation to US tax reform. The most important factors to consider in this regard are the location of current IP (US, foreign onshore, foreign offshore), foreign and US tax rates, connectedness to business/supply chain/customers, substance, the interplay of the new GILTI, FDII, BEAT taxes and costs of IP migration/unwind.

Rest-of-world responses to US tax reform

Nations around the world will be impacted by US tax reform, but the US' trading partners are being careful to react to US tax reform in a thoughtful and measured manner, taking time to assess the implications of US reform on their foreign direct investment (FDI) inflows and on taxpayer and investor behaviors.

For the past two annual editions, the EY *Tax policy outlooks* have noted that a number of countries are either creating or enhancing their R&D and other business incentives, looking for "acceptable" ways to stay tax competitive within the constraints of BEPS. Whether this activity accelerates further in light of US tax reform is open to debate, but it would not be surprising. Likewise, the IP-related measures in the US tax reform package may take some time to impact taxpayer and investor behaviors. All things considered, this is an area to watch with interest in the coming months and years.

The European Union is believed to be assessing whether to take action against certain TCJA provisions, suggesting that certain of the international tax provisions are discriminatory or in violation of World Trade Organization (WTO) rules. The tax press is reporting that the EU has requested that the OECD Forum on Harmful Tax Practices conduct a "fast track" review of certain of the TCJA's provisions. The request reportedly came after a meeting of EU finance ministers in which the Europeans discussed how to react to the tax reform law and whether to take action in the WTO.

According to the report, a recent EU document states that the new BEAT may contravene the OECD Model Tax Convention's Article 24 on non-discrimination. The document reportedly also addresses the TCJA's FDII provision.

All this comes after the European Commission (EC) indicated it will survey European MNCs on how the TCJA's international tax provisions may affect them. A questionnaire has been issued to companies, asking them to describe the type of transactions and business operations that will be affected by certain TCJA provisions, and whether they plan to change their business strategies as a result.

Transparency

A further development at EU-level impacting IP planning in general is that the Council of the EU has reached agreement on a Directive aimed at boosting transparency to tackle what it sees as aggressive cross-border tax planning.[2]

The Directive (known as the Mandatory Disclosure Regime), which took effect on 25 June 2018, will require "intermediaries" such as tax advisors, accountants and lawyers that design and/or promote tax planning arrangements to report transactions and arrangements that are considered by the EU to be potentially aggressive. If there is no intermediary utilized, the obligation falls to the taxpayer.

Given the breadth of the transactions and arrangements covered, relevant reporting obligations in respect of IP sale or transfer will likely result for both companies headquartered in Europe and for non-European companies active in Europe. Determining if there is a reportable cross-border arrangement raises complex technical and procedural issues for MNEs and their advisors.

The OECD-level debate on IP

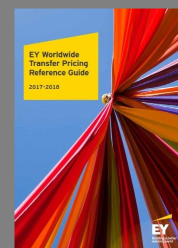
Arguably the most important development in terms of taxation of IP that will continue to impact MNCs with IP structures is the OECD's BEPS project, specifically Actions 8-10. The recommendations of Actions 8-10 have been included in the revised Chapters I and VI of the OECD Transfer Pricing Guidelines published in 2017, and discussions around modified Chapters I and VI indicate a general international consensus with respect to the definition and valuation of IP, with some notable exceptions.

There does, however, seem to be a fundamental disagreement between OECD member states as to the interpretation of the guidance provided in Chapter I regarding risk, i.e., whether contractual arrangements between related parties in general, including when these involve IP, should be respected, or if they can be recast based on the six-step risk framework that is laid out in Chapter VI of the revised OECD Guidelines. Some OECD members argue that contractual allocations of risk should be respected only when they are supported by actual decision-making.

[2] *EU publishes Directive on new mandatory transparency rules for intermediaries and taxpayers – EY Global Tax Alert, 5 June 2018. ey.com/gl/en/services/tax/international-tax/alert--eu-publishes-directive-on-new-mandatory-transparency-rules-for-intermediaries-and-taxpayers*

Extend your information reach
The 2017-18 EY *Worldwide Transfer Pricing Reference Guide*

The information included in the 2017-18 EY Worldwide Transfer Pricing Global Reference Guide covers 119 countries and provides an overview regarding transfer pricing tax laws, regulations and rulings; OECD Guidelines treatment; documentation requirements; transfer pricing returns and related party disclosures; transfer pricing documentation and disclosure timelines; BEPS Action 13 requirements; transfer pricing methods; benchmarking requirements; transfer pricing penalties and relief from penalties; statutes of limitations on transfer pricing assessments; likelihood of transfer pricing scrutiny and related audits by the tax authorities; and opportunities for advance pricing agreements (APAs). Access the guide at ey.com/transferpricingguide.



The summary section of the revisions to Section D of Chapter I of the Transfer Pricing Guidelines of the Actions 8-10 – 2015 Final reports, states the following:

"[…]In summary, the revisions respond to the mandate to prevent inappropriate returns to capital and misallocation of risk by encouraging thoroughness in determining the actual arrangements between the associated enterprises so that pricing takes into account the actual contributions of those parties, including risks actually assumed, and by authorizing the non-recognition of transactions which make no commercial sense."

"While there still seems to be a general agreement on the arm's-length standard when it comes to IP transactions, some of the new guidance in Chapter I is subject to interpretation" comments David Canale, EY Global & Americas Transfer Pricing Controversy Leader. "With that, the risk of transactions (including IP transactions) being recharacterized, and an allocation of profits being made by tax authorities that is different from the one contractually agreed by related parties, has clearly increased."

While the revised Chapter I of the OECD Guidelines deals with recognition and accurate delineation of transactions by emphasizing the role of risk in transfer pricing, the revised Chapter VI clarifies that "legal ownership alone does not necessarily generate a right to all (or indeed any) of the return that is generated by the exploitation of the intangible. The group companies performing important functions, controlling economically significant risks and contributing assets, as determined through the accurate delineation of the actual transaction, will be entitled to an appropriate return reflecting the value of their contributions. […]."

Chapter VI defines important functions related to IP as the development, enhancement, maintenance, protection, and exploitation of the intangible, the so-called "DEMPE" functions. (See also China box to right).

While this definition may seem intuitive, the challenge will be that tax administrations may be tempted to argue that taxpayers in their jurisdictions have performed valuable DEMPE functions, using that argument to challenge the existing contractual arrangements.

The implication of the revised Chapters I and VI is that certain existing IP structures based on allocating significant profits to an IP owner and obtaining the benefits of a preferential IP taxation regime, need to be reviewed to ensure that the IP owner carries out not only the funding of the IP development but also the decision-making and control over the DEMPE functions, as well as an important part of the execution of the related R&D activity.

MNCs that do not to align decision-making and control with IP ownership may see the advantages available to them under preferential IP regimes reduced, and are therefore advised to assess and evaluate their current transfer pricing structures.

Jurisdiction perspectives: China

According to Joanne Su, Asia-Pacific Transfer Pricing Markets Leader in EY China, IP transactions are high on the agenda of the Chinese State Administration of Taxation (SAT). On 1 April 2017, SAT issued *SAT Bulletin Gonggao [2017] No. 6* (Bulletin 6) providing new transfer pricing guidance and strengthening the Mutual Agreement Procedure (MAP) process. Among other things, Bulletin 6 enhances the alignment of China's transfer pricing rules with the OECD's standards regarding IP.

While Bulletin 6 does already contain the five DEMPE functions under the OECD Guidelines that are relevant in determining the allocation of profits from use of intangible property, it also adds promotion as a sixth function (i.e., DEMPEP). This demonstrates the importance that China places on value created through marketing activities undertaken by Chinese companies.

Bulletin 6 also incorporates two provisions that reflect the OECD BEPS guidance:

- An entity that merely funds intangible development activities but does not perform any DEMPEP functions should only be entitled to earn a reasonable financing return; and
- An entity that owns mere legal ownership but does not control financing functions or risks should not be entitled to any intangible-related profits.

Additionally, Bulletin 6 provides guidance as to how Chinese tax authorities should review intercompany royalty transactions. Tax inspectors are advised to pay particular attention to whether: (i) the value of the licensed intangibles has declined since the royalty was initially established; (ii) price adjustment clauses are commonly found in third party contracts in the industry; (iii) functions as well as assets and risks have changed; and (iv) the licensee has performed DEMPEP functions for which it has not been reasonably compensated.

"In China, authorities have always been sensitive to IP that has been developed outside of China but is being used by Chinese taxpayers," says Joanne. "Historically, SAT representatives have criticized that Chinese companies keep paying the same royalty rates over an extended period of time, even though the underlying IP hasn't been maintained or upgraded during that time period."

The Chinese tax administration seems to be putting less emphasis on the topic of location savings as compensable IP as it did in the past, which presumably has to do with the fact that location savings from manufacturing in China have become less relevant in recent years.

China (continued)

"With the new transfer pricing regulations based on the OECD BEPS-Initiative, Chinese taxpayers really need to do a proper valuation of their IP and the benefit of the IP to the China subsidiary," says Joanne. "In the past, a lot of the challenges and disallowances of intercompany charges stemmed from insufficient transfer pricing documentation. Consistency of the taxpayer's position regarding IP around the world is crucially important."

In terms of possible reactions to US tax reform specifically related to the preferential tax rates for IP-related there have so far been no indications from the Chinese tax authorities if and how they intend counter the developments in the US.

Jurisdiction perspectives: Germany

As a large export nation with many IP-owning companies, Germany's tax authorities have been and will continue to be aggressive as it relates to assessing deemed IP transfers out of Germany.

Recent tax audits in Germany have centered on issues such as which entities should be entitled to intangible-related returns, how the entities involved should be characterized and how arm's length royalties should be calculated.

German tax authorities generally follow the OECD BEPS Action 8-10 guidance with respect to the DEMPE and control of risks framework. Since 2008, however, there has been extensive legislation in place on so-called "transfers of functions," which implicitly and explicitly includes guidance on the valuation of intangibles.

These rules propose the application of the hypothetical arm's-length test in cases where no sufficiently comparable arm's-length values can be identified – which is assumed to be often the case with intangibles. For this purpose, the taxpayer must use the functional analysis and internal business plans to identify the transferor's minimum price and the transferee's maximum price (bargaining range).

This two-sided approach to IP valuation, while mentioned in the OECD Guidelines, is generally not required in other countries.

Germany (continued)

While having robust and detailed documentation with strong economic analyses available may reduce the risk of transfer pricing adjustments, tax authorities in Germany have a tendency to challenge high-risk transactions, such as IP-related transactions, irrespective of how robust the documentation is. Companies should therefore expect continued scrutiny and controversy around IP-related matters that affect Germany.

A further key development is that, effective 1 January 2018, Germany has introduced a royalty limitation rule that denies the deductibility of royalty payments made by a German entity to a related entity that benefits from a preferential IP regime that does not meet the OECD BEPS Action 5 modified nexus requirements.

The deduction is (partly) denied to the extent that the tax rate in the "harmful" IP regime is lower than 25%. For example, if the tax rate in preferential regime is 10%, then 60% (15/25) of the German royalty expenses are non-deductible.

Jurisdiction perspectives: India

Since the enactment of transfer pricing regulations in India, taxpayers have faced a number of compliance issues surrounding complex transactions that may be carried out by an MNC.

In a scenario where IP is sold by the taxpayer to its related entity, the Indian Revenue Authorities (IRA) have, in certain cases, alleged that the transaction has been undertaken at a value that is not considered to be at arm's length, which in turn is a result of the inherent subjective nature of valuation methodology.

Thus, the issues in connection with transfer of IP usually revolve around the difference in the valuation methodology/approach, and resulting assumptions of the taxpayer and the IRA.

The IRA, even at the APA level, often examine the assumptions and risk parameters considered while arriving at the discount rate adopted by a taxpayer in discounting projected cash flows in order to determine the value of IP. This is also due to the fact that there are multiple sources/databases of information for determining the country risk premium and growth rates, for example, that are used in projecting cash flows.

India (continued)

Other reasons for differences in IP valuations by the IRA are the differences in timing of the valuation performed by the taxpayers and the IRA as well as lack of robust documentation by taxpayers to support the assumptions adopted in their valuation reports.

While the term "intangible property" has been clearly defined in Indian's tax law, there still remains ambiguity on the method/approach to be adopted in the valuation of IP. "It would be helpful if the IRA were to consider providing additional guidance on the method/approach to be adopted while valuing IP, as well as the specific documentation that taxpayers should provide in support," says Vijay Iyer, EY India Transfer Pricing Leader. "This would significantly help taxpayers in establishing the arm's length nature of their IP transfers during scrutiny proceedings and consequently reduce litigation in India on this front."

Jurisdiction perspectives: South Korea

Transfer pricing related to IP transactions is a key focus tax audits in South Korea. Sang Min Ahn of EY's Asia-Pacific Transfer Pricing Desk in New York expects Korean tax authorities to scrutinize IP transactions more closely in the future given that with the introduction of the BEPS Master File requirement by the Ministry of Strategy and Finance, the South Korean tax authorities will now have a better understanding of relevant information regarding intercompany IP transfers, including the type and the date on which IP has been transferred, who the transferor and transferee are and the value of the IP.

"Since Korean TP regulations do not provide specific guidance regarding IP, the OECD Guidelines are used as a reference in Korean tax audits as well as the appeals process" says Sang Min. "Recent tax audits have shown that the South Korean tax authorities consider standard valuation techniques (i.e. the income method based on discounted cash flows) as a reasonable transfer pricing method in calculating arm's-length prices for IP when a valid Comparable Uncontrolled Price (CUP) is not available."

US tax reform and the tax challenges that certain technology companies are facing in Europe have been significant news in Korea and as a consequence it is expected that the South Korean tax authorities will aggressively audit IP transactions going forward. Audit-ready transfer pricing documentation is therefore a must. Companies need to be able to explain the rationale for certain IP transactions and have proper intercompany agreements in place in addition to meeting the new BEPS Action 13 requirements.

Recap

For our series of articles, we identified eight key transfer pricing risks for 2018 and beyond. A common thread can be observed among the entire set:

- Current developments are characterized by the simultaneous pursuit – and inherent tension of – international tax rule harmonization to eliminate certain types of tax competition, and ongoing competition between countries to attract businesses. This ongoing competition is reviving old differences of opinion regarding certain tax matters, as well as creating new ones.
- While the BEPS initiative has led to a consensus on certain transfer pricing matters, it has not eliminated fundamental differences in opinion regarding certain technical topics.
- The new transfer pricing standards established by the BEPS initiative have led to more transparency in tax matters. While it remains to be seen how governments will deal with increased transparency, it is very likely that the nature of transfer pricing audits will change going forward given that tax authorities are now better able to spot potential high-risk areas, i.e., tax authorities will probably spend less time on understanding the facts and move more quickly to analyze potential high-risk transactions and to then propose adjustments.

Call to action

A number of leading practices emerge from our review of multilateral and national developments related to the sale and transfer of IP.

First, dealing with the sale or transfer of IP should be just one tactical strand of a company's wider intangibles strategy. That means developing and sustaining an effective set of specific processes, roles, metrics and governance around the invention, funding, ownership and exploitation of intangible assets globally.

Second, MNCs should review the impact of the new US tax provisions on the tax cost of their current global operating model, including cost-effective changes to location of certain functions and risks. In addition, companies should review and re-evaluate the location of their IP and R&D functions.

Third, having robust, audit-ready transfer pricing documentation that does not leave any relevant aspect of IP open to interpretation is vital.

The main characteristics of audit-ready transfer pricing documentation are:

- Proper identification/delineation of IP
- Evidence that IP ownership is aligned with an MNC's value chain(s)
- Clear identification of contributions to IP development, and that entities contributing to IP development have received an arm's-length compensation for their contributions

Final thoughts

While the majority of the transfer pricing risks identified in this series are not new in nature, companies should expect that these issues will either resurface or grow with renewed vigor given that tax administrations are now far better able to identify potential transfer pricing issues.

Moreover, US tax reform, rather than simplifying the taxation of cross-border transactions, has further complicated it, and could lead to a significant response from governments around the world.

And, with the digital debate set to be a key issue in the 2018 and beyond, there is simply little likelihood that the scrutiny of the value delivered by intangibles assets will reduce.

Companies should therefore be prepared for a prolonged and challenging time of uncertainty with respect to this area.

Extend your information reach

EY *Global Transfer Pricing alerts*

Transfer pricing is perhaps the area of taxation most in flux today. Sitting at the heart of many of the BEPS actions, transfer pricing change continues to impact countries around the world. As a result, staying up-to-date with national change has never been so important, but also never so difficult.

EY Global Tax Alerts – including Global Transfer Pricing alerts – are published on a daily basis by EY. They are captured in the EY Global Tax Alert Library on ey.com, an information source for tax professionals around the world.

Access the library at *ey.com/taxalerts*.

EY Client Portal | EY Intranet | Library | About us | Newsroom | Connect with us | Global (English)

EY Building a better working world

Search

Home | Insights | Industries | Services | Careers | Alumni

Home » Services » Tax » US IRS announces new template for APA agreements

Global Tax Alert (News from Transfer Pricing) | 16 May 2018

US IRS announces new template for APA agreements

See tax alerts by: Date | Topic | Country | Advanced filtering

Share

The United States (US) Internal Revenue Service (IRS) released on 11 May 2018, a revised mandatory template for Advance Pricing Agreements (APAs) to be included in all taxpayer APA requests.

Background and detailed discussion

An APA is an agreement between the IRS and a taxpayer under which the IRS agrees not to seek a transfer pricing adjustment under Internal Revenue Code Section 482 for one or more specific covered transaction(s) if the taxpayer files its tax return for a covered year based on the agreed transfer pricing method(s) (TPM). The APA process is a voluntary program designed to resolve actual or potential transfer pricing disputes in a principled, cooperative manner, as an alternative to the traditional examination process.

Revenue Procedure 2015-41 (Rev. Proc. 2015-41) provides guidance on the process of requesting and obtaining APAs from the Advance Pricing and Mutual Agreement program (APMA). Of particular importance for this Alert is Section 1 (Content of complete APA request), Sub-section .03 (Exhibits) of the Appendix to Rev. Proc. 2015-41, which describes the order and content of the 22 exhibits to be included in every APA request. The new template released by the IRS is the basis for the draft APA agreement that taxpayers must file as Exhibit 15 of their APA request.

Contact us

For additional information with respect to this Alert, please contact the following:

Ernst & Young LLP, Washington, DC
- Dave Canale
- Dick McAlonan
- Craig Sharon
- Miller Williams
- Carlos Mallo

Ernst & Young LLP, San Jose
- Ameet Kapoor

See our global guides
- Capital and Fixed Assets Guide
- Corporate Tax Guide
- Digital Tax Guide

EY | Assurance | Tax | Transactions | Advisory

About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

EY Tax Policy and Controversy services
Our business tax services are designed to help you meet your business tax compliance and advisory needs. Our tax professionals draw on their diverse perspectives and skills to give you seamless global service in planning, financial accounting, tax compliance and accounting, and maintaining effective relationships with the tax authorities. Our talented people, consistent global methodologies and unwavering commitment to quality service give you all you need to build the strong compliance and reporting foundations and sustainable tax strategies that help your business succeed.

© 2018 EYGM Limited.
All Rights Reserved.

EYG no. 010332-18Gbl

ED None

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax or other professional advice. Please refer to your advisors for specific advice.

ey.com

The opinions of third parties set out in this publication are not necessarily the opinions of the global EY organization or its member firms. Moreover, they should be viewed in the context of the time they were expressed.

Circular 230 Statement: Any US tax advice contained herein is not intended or written to be used, and cannot be used, for the purpose of avoiding penalties that may be imposed under the Internal Revenue Code or applicable state or local tax law provisions.