BEPS and The increased importance of Functional Analysis

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Agenda

► BEPS and the increased importance of functional analysis
  ► Risk
  ► Intangibles
  ► Intra-group services and CCAs
  ► Customs

► BEPS – Are You Ready?
The Increased Importance of Functional Analysis
BEPS project
BEPS focus areas

Comprehensive action plan impacting majority of existing multinationals structures. Main themes are consistency, substance and transparency.

- Action 1: Address the tax challenges of the digital economy
- Action 8: Consider transfer pricing for intangibles
- Action 9: Consider transfer pricing for risks and capital
- Action 10: Consider transfer pricing for other high-risk transactions

- Action 2: Neutralise the effects of hybrid mismatch arrangements
- Action 3: Strengthen CFC rules
- Action 4: Limit base erosion via interest deductions and other financial payments
- Action 6: Prevent treaty abuse
- Action 7: Prevent the artificial avoidance of permanent establishment status

- Action 5: Counter harmful tax practices more effectively, taking into account transparency and substance
- Action 11: Establish methodologies to collect and analyse data on BEPS and actions addressing it
- Action 12: Require taxpayers to disclose their aggressive tax planning arrangements
- Action 13: Re-examine transfer pricing documentation
- Action 14: Making dispute resolution mechanisms more effective
- Action 15: Develop of a multilateral instrument for amending bilateral tax treaties
The OECD BEPS Project
What does the BEPS package bring?

- Minimum standards
- Reinforced international standards on tax treaties and transfer pricing
- Common approaches and best practices for domestic law measures
- Analytical reports with recommendations (digital economy and multilateral instrument)
- Detailed report on measuring BEPS
Revised Section D of Chapter I of the OECD Guidelines

- Accurately delineate the actual transactions by analyzing the contractual relations together with evidence of the actual conduct of the parties.
- Detailed guidance on analyzing risks as integral part of a functional analysis, including a new six-step analytical framework.
- The party assuming a risk should control the risk and have the financial capacity to assume the risk.
- A capital-rich MNE group member without any other relevant economic activities (“cash boxes”) that provides funding, but cannot control financial risks in relation to the funding, will attain no more than a risk-free return, or less if the transaction is commercial irrational.

- Shift from the legal form to the economic reality of a transaction
- Reallocation risk possible
- More detailed functional analysis is needed
Guidance on risk

- Risk is defined as
  
  "the effect of uncertainty on the objectives of the business"

- Risk assumption is defined as
  
  "taking on the upside and downside consequences of the risk with the result that the party assuming the risk will bear the financial and other consequences if the risk materializes."

- Risk (and related returns) should be allocated to the party that contractually assumes the risk, unless it does not exercise control over the risk and has the financial capacity to assume the risk
Allocation of Risk

New Six-step Framework for Analysis of Risks

1. Identification of economically significant risks with specificity
2. Determination of contractual assumption of the specific risk
3. Functional analysis in relation to risk
4. Interpreting steps 1-3
5. Allocation of risk
6. Pricing the transactions taking into account the allocation of risks

If the associated enterprise (contractually) assuming the risk does not exercise control over the risk or does not have the financial capacity to assume the risk, then the risk should be allocated to the enterprise exercising control and having the financial capacity to assume the risk.
Step 1 – development risk is significant risk

Step 2 – Under the contract, Co A assumes development risk

Step 3 – Functional analysis shows that co A controls the risk through exercising its capability and authority in taking decisions on whether and how to take on the risk, including the decision:

▶ To perform part of development work itself;
▶ To seek specialist input;
▶ To hire co B;
▶ Of the type of research and objectives assigned to Co B;
▶ Of the budget allocated to co B

Step 3 – Functional analysis shows that company A has financial capacity to assume the risk.
Example

- **Step 1** – non-utilization risk and supply chain risk are significant risks
- **Step 2** – Under the contract, Co A assumes these risks
- **Step 3** – Functional analysis shows Co B build and equipped plant according to Co A specs; products manufactured according tech requirements and designs Co A, volume level determined by Co A, Co A runs supply chain incl. procurement components and raw materials. Co A performs regular quality checks;
- **Step 3** – Co A and Co B have financial capacity to assume their risk.

Co B manufacturers products for Co A

Company B

Company A
Step 4

Step 4: interpreting steps 1-3

- Do related parties follow contractual terms?
- Does party assuming risk exercise control over the risk and has it financial capacity to assume risk?

Significance step 4 depends on findings
Risk management

- Risk management is defined as the *function of assessing and responding to risk associated with commercial activity*.

- Risk management comprises three elements:
  1. the *capability* to make decisions to take on, lay off, or decline a risk-bearing opportunity, together with the *actual performance* of that decision-making function,
  2. the *capability* to make decisions on whether and how to respond to the risks associated with the opportunity, together with the *actual performance* of that decision-making function, and
  3. the capability to mitigate risk, i.e. the *capability* to take measures that affect risk outcomes, together with *actual performance* of such risk mitigation

- Control over risk requires the first two elements of risk management and the capability to determine the objectives of the outsourced activities.

- Financial capacity to assume a risk is defined as access to funding to take on the risk or to lay off the risk, to pay for the risk mitigation functions and to bear the consequences of risk materialization.
Requirements

► Capability and the actual performance of such functions relative to a specific risk involve:
  ► an understanding of the risk based on a relevant analysis of the information required for assessing the foreseeable downside and upside risks outcomes

► Decision makers:
  ► Should possess competence and experience in area of particular risk
  ► Understand impact of their decision on business
  ► Have access to relevant information
    ► Gathering themselves
    ► Exercising authority to specify and obtain information
  ► Have capability to determine objectives of gathering/obtaining information, assess whether right info is gathered and analyses are adequately made

► Only performing risk mitigation activities or making the decisions that shape the policy environment in which the specific risks are assumed to exercise control over a specific risk is not sufficient

► The mere formalizing of decision making in any form, does not qualify as a decision making function exercising control over a risk.
Example

Investment decision

- Step 1 – investment risk and non utilization asset are significant risks;
- Step 2 – Service contract between Co A and Co C. Contract does not address utilization risk;
- Step 3 – Co B made investment decision, incl. specifying characteristics asset to be purchased;
- Step 3 – Co B decides how to utilise the asset, markets the asset’s capabilities to 3rd party customers, negotiates contracts with 3rd party customers, assures asset is delivered to 3rd parties and installed appropriately;
- Step 3 – Cos A, B and C have financial capacity to assume their respective risks

Co A acquired legal ownership tangible asset and enters into contracts for use asset with 3rd party customers

Services contract

Company A

Company B

Company C
Transfer Pricing analysis

“in a TP analysis of a matter involving intangibles, it is important to identify the relevant intangibles with specificity”

Functional analysis should:
- Identify relevant intangibles
- The manner in which they contribute to creation of value
- Important functions performed and risks assumed relative to DEMPE of intangibles
- Manner in which they interact with other intangibles and business operations to create value

“While it may be appropriate to aggregate intangibles for purposes of determining arm’s length conditions in certain cases, it is not sufficient to suggest that vaguely specified or undifferentiated intangibles have an effect on arm’s length prices or other conditions”.

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The Increased Importance of Functional Analysis
### Six step process for TP analysis of Intangibles

<table>
<thead>
<tr>
<th>Step</th>
<th>Task</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Identify the intangibles used or transferred in the transaction with specificity</td>
</tr>
<tr>
<td>2.</td>
<td>Identify the full contractual arrangements, with special emphasis on determining legal ownership of intangibles</td>
</tr>
<tr>
<td>3.</td>
<td>Detailed functional analysis (DEMPE functions, assets and risks)</td>
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<td>4.</td>
<td>Confirm consistency between the terms of the contractual arrangements and the conduct of the parties (focus on DEMPE functions and risks, etc)</td>
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<td>5.</td>
<td>Delineate the actual controlled transactions related to the DEMPE functions and risks</td>
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<tr>
<td>6.</td>
<td>Where possible’ determine arm’s length prices for contributions</td>
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- The allocation of returns from the exploitation of intangibles should especially be based on which parties perform the DEMPE functions, assume the risks and provide funds or other assets.
- Legal ownership becomes less important.

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**3 November 2015**

**The Increased Importance of Functional Analysis**
## Identifying Intangibles

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

| Relationship capital (innovation community, ecosystem and supply chain partnerships) |
| Reputational value |
| Key human capital |

### Explicitly Excluded:
- Group synergies
- Market specific characteristics

### Non-registered IP (Illustrative examples)
- Know-how and trade secrets
- Rights under contracts
- Marketing intangibles (incl. marketing strategy know-how)
- Distribution network and customer lists
- Product design and technology
- Process technology provided to buyers
- Supplier lists and procurement processes

### Registered IP (Illustrative examples)
- Patents, designs, licences and rights
- Trademarks, trade names, domain names and brands

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

Are you in a position to identify all the intangibles and IP owned, controlled or used in your business and to prove an ownership chain?
DEMPE functions are key

Development of intangible asset

Enhancing value of intangible asset

Maintenance of intangible asset (e.g., quality control)

Protection of intangible asset against infringement

Exploitation

Potential impact on supply chain structures

► Legal ownership and the funding of the development of an intangible, without performing and controlling all of the functions, would not entitle to collect all returns derived from the exploitation of such an intangible

► Profit split method is suggested when key DEMPE functions are outsourced

► If DEMPE contributors are remunerated on a one-sided basis, reliability of transfer pricing reduced

► Risk-adjusted rate of return to pure funders, if funder manages the financial risks
Example

Co. A and Co. B decide to develop an intangible
- Expected to take 5 years to develop before possible commercial exploitation, and is anticipated to have value for 10 years after initial exploitation.
- Co. B to perform and control all activities related to the intangible
- Co. A to provide all funding associated with the development ($100M per year for 5 years) and become legal owner of the intangible
- Profits expected to be $550M per year (Year 6 to 15).
- Co. B will license intangible from Co. A and make contingent payments based on returns of purportedly comparable licensees. Co. B will be left with an anticipated return of $200M per year from selling products based on the intangible

OECD conclusion
- Co. A (and not Co. B) should be considered tested party
- Co. A’s contribution is solely R&D funding and some inherent risk associated with that funding. Co. A’s anticipated remuneration should be a risk-adjusted rate of anticipated return on its funding commitment (assume to be $110M per year or 20% of anticipated profits)
- Co. B would be entitled to all remaining anticipated income ($440M or 80% of anticipated profits), rather than $200M per year as claimed by the taxpayer
**Example**

**Facts**
- Co. X manufactures product Y and sells to distributors for further resale in their local markets.
- Product Y is well recognized and attracts a premium compared to the competitor products. Co. X is entitled to such premium as legal owner and developer of the trademark.
- In year 2, Co. S established acting as super distributor and invoicing center. Product Y is now sold via Co. S taking title to the goods to distributors.
- Co. S begins in year 2 to reimburse distributors for a portion of their advertising costs at the same time adjusting the TP upward so that the distributors operating profit remains the same.
- In year 3, the TP charged by Co. X to Co. S is reduced. Reason: Co. S is now entitled to income related to intangibles created through the advertising costs it has borne.

**OECD conclusion**
- Co. S is not entitled to any income derived from the exploitation of intangibles as it performs no functions, bears and controls no risk and in substance bears no costs related to the development, enhancement, maintenance or protection of intangibles.
Valuation Techniques Can Be Useful Tools

• “Valuation techniques may be used by taxpayers and tax administrations as part of one of the five OECD transfer pricing methods […], or as a tool that can be usefully applied”

• “In particular, the application of income based valuation techniques, especially valuation techniques premised on the calculation of the discounted value of projected future income streams or cash flows […] may be particularly useful when properly applied”

• “it is necessary to apply such techniques in a manner that is consistent with the arm’s length principle and the principles of these Guidelines”

• Valuations of intangibles in purchase price allocations performed for accounting purposes are not determinative for TP purposes
Areas of Concern in applying Discounted Cash Flow methods

- Accuracy of financial projections
- Assumptions regarding growth rates
- Discount rates
- Useful life of intangibles and terminal values
- Assumptions regarding taxes

► Valuation techniques based on the discounted value of projected cash flows can be very volatile

► Small changes in the assumptions of the underlying valuation model / valuation parameters can lead to large differences in the intangible value

► Taxpayers should be prepared to defend the reasonableness of such assumptions and valuation parameters
Information asymmetry between taxpayer and the tax administrations may increase the difficulty of the tax administration in verifying the arm’s length basis on which pricing was determined.

If the taxpayer cannot demonstrate the pricing based on a thorough TP analysis:

- There are no reliable comparables; and
- Financial projections and other assumptions used for the valuation are highly uncertain at time of transaction.

“Tax administrations can consider ex-post outcomes as presumptive evidence about the appropriateness of the ex-ante pricing arrangements.”

Several exceptions due to unforeseen events, variation threshold of 20%, time periods, and bilateral or multilateral APA.
Example: Valuation of HTVI

**Facts:**
- A and B are part of a MNE group in the pharmaceutical industry.
- Technology IP dispersed throughout the MNE group. IP centralized at B.
- A owns patented compound that has not obtained market approval yet. This is transferred to B.
- H/L DCF valuation is conducted without thorough functional analysis.
- The product became much more successful than what was forecasted in the DCF valuation.

**Issue:**
- Country A disagrees with the DCF valuation.
- Ex post outcomes considered by Country A as presumptive evidence to assess appropriateness of ex ante pricing arrangement.

**Takeaway:**
- Valuation parameters should consider functional analysis.
Intra-group services and CCAs
Revisions to Chapter VII of the OECD Guidelines intended to balance the need to charge for low value adding services / Head Office expense and the need to protect the tax base of payer countries

- New guidance regarding an elective, simplified TP approach for low value-adding (LVA) intra-group services:
  - Ability for tax administrations to include a threshold above which the simplified approach may be denied
  - A large group of countries will endorse the approach by 2018
  - Follow-up implementation activities to follow in 2016 to entice more countries to accept the guidance
- Some changes and clarifications to other paragraphs of Chapter VII, including shareholder activities

- The simplified approach is intended to reduce compliance efforts and provide greater certainty to MNE groups, however, focus on non-LVA services
Head office expenses

Key features of new guidance on low value-adding services

- A standard definition of LVA services
- An elective, simplified approach to determine arm’s length charges:
  - Simplified benefits test
  - A process for determining the costs associated with LVA services
  - Reasonable cost allocation methodologies
  - Standard mark-up of 5%
  - Should be applied as far as practical on a consistent basis either group-wide or on a regional or divisional subgroup
- Prescriptive guidance on documentation and reporting
- Suggests withholding tax is only applied to the profit element

Definition of low value adding services:

- Of a supportive nature
- Are not part of the core business
- Do not require the use of valuable intangibles and do not lead to their creation
- Do not give rise to or involve the assumption of substantial risks
- Typically will not include R&D, Marketing, Sales, distribution and financial transactions
More focus on non safe harbor services?

➤ “Any consideration of possible duplication of services needs to identify the nature of the services in detail, and reason why the company appears to be duplicating costs”

➤ “It is essential, however, that reliable documentation is provided to the tax administration to verify that the costs have been incurred by the service provider.”
New Chapter VIII on CCAs

► alignment guidance on CCAs with new guidance on control of risk and on intangibles transactions. Key points:
  ► Expectation mutual benefit is pre-requisite for participating in CCA
  ► Control is pre-requisite to be considered as a participant in a CCA.
  ► Value of contributions made by participants must be in proportion to their reasonably anticipated benefits from the CCA.
    ► Value of each participant’s contribution should be determined in line with value that would be placed on it by independent enterprises in comparable circumstances.
    ► While contributions should be measured based on value, it is recognizes that it may be more practical to compensate current contributions at cost. However, this approach may not be appropriate where the contribution of different participants differ in nature (for instance, where some participants contribute services and others provide intangibles or other assets).
Transfer pricing and customs

- WCO guide on transfer pricing and customs valuation
- Changing customs valuation rules under the Union Customs Code in the EU
Pragmatic approach to utilizing transfer pricing documentation to support customs value

A list of "good practices" for customs administrations, including the encouragement to customs administrations to consider information derived from transfer pricing studies when examining related party transactions
A list of "good practices" for international business, including:

- Coordination among tax and customs departments and advisors on transfer prices
- Consider the needs of customs authorities when preparing transfer pricing documentation or developing Advance Pricing Agreements
- With appropriate consideration of local requirements, provide customs administrations with advance notification that post-importation adjustments may occur
- Work with customs authorities to provide interpretation into a customs framework of transfer pricing analyses and data
In October 2013, the Union Customs Code ("UCC") was adopted. Most provisions of the UCC will be applicable as of 1 May 2016. The Community Customs Code ("CCC") — which currently applies — will be repealed thereafter. The UCC will entail a number of material changes in the EU customs legislation.

The European Commission has been assigned with the task to ensure that Delegated Acts ("DA") and Implementing Acts ("IA") enter into force sufficiently in advance to allow EU Member States to implement the UCC in a timely manner:

- In order to supplement or amend certain non-essential elements of the UCC, the European Commission has the power to adopt “Delegated Acts”
- In order to ensure uniform conditions for the implementation of the UCC, implementing powers have been conferred on the European Commission
- On 1 July, 2 October and 20 October 2015 the European Commission shared new drafts of the Delegated Acts and Implementing Acts with the Member States.
- It is expected that the DA and the IA will be adopted in November 2015, subject to minor changes.
Value of goods for customs purposes: Changes under UCC

- There will be substantial changes in the field of customs valuation which can have a considerable financial impact on companies that import dutiable goods into the EU:
  - First sale for export abolished;
  - Grandfathering of first sale for export until end of 2017;
  - Royalties and license fees: will be part of the customs value in many more cases than presently.
Royalties and license fees are included in the customs value to prevent the undervaluation of goods.

Payments in respect of patents, designs, trademarks, copyrights etc. are added to the price paid or payable if:

- These elements are related to the goods being valued
- The buyer must pay these elements, either directly or indirectly, as a condition of sale

Under the UCC, the “condition of sale” requirement is deemed to be met if:

- The seller or a person related to the seller requires the buyer to make this payment, or
- The payment by the buyer is made to satisfy an obligation of the seller, in accordance with contractual obligations,
  or
- The goods cannot be sold to, or purchased by the buyer without payment of the royalties or license fees to a licensor

The third element seems to include a variety of situations and leaves ample room for interpretation.

Taxable scope seems to be increased under the UCC. As a consequence royalties which under current legislation are not added to the customs value, are under UCC likely to be added to the customs value;
With regard to trademark royalties, the CCC provides an exception to the general treatment of royalties and license fees:

- If the buyer is free to source its products from suppliers unrelated to the seller, trademark royalties do not have to be added to the transaction value. Currently, trademark contracts often include a “freedom of source” clause which enables that trademark royalties do not increase the taxable scope.

Under the UCC, the trademark exception is abolished: Trademark royalties are typically included in the transaction value, if these are related to the goods and are paid as a condition of sale (see previous slide for the requirements).

There is a global trend to imply a condition of sale when an importer is related to the trademark licensor, even when the seller of goods is unrelated. As the EU is following this trend, many trademark royalties currently exempt from duty will become dutiable additions to value.

**Example**

<table>
<thead>
<tr>
<th>Manufacturer China</th>
<th>Distribution Co EU</th>
<th>IP Co</th>
</tr>
</thead>
<tbody>
<tr>
<td>€400</td>
<td>€100</td>
<td></td>
</tr>
</tbody>
</table>

CCC: Customs duty calculated on €400 rather than €500 provided that the buyer is free to source the goods from suppliers unrelated to the seller.

UCC: Customs duty calculated on €500.
Royalties for customs purposes: Key changes

► Community Customs Code:
  ► When the buyer pays royalties or license fees to a third party, the condition of sale requirement is not considered as met unless the seller or a person related to the seller requires the buyer to make that payment
  ► Trademarks are not dutiable if "Freedom of source" applies

► Union Customs Code:
  ► Condition of sale requirement is extended to the situation whereby the goods cannot be sold to, or purchased by the buyer without payment of the royalties or license fees to a licensor
  ► Trademark exception abolished
Case study
Transfer pricing and customs

Invoice 1 = €90
Invoice 2 + Royalty = €120

Invoice 1 = €90
Invoice 2 = €100

IP CO.

Procurement Company

Goods

Royalty = €20
Case study
Transfer pricing and customs

Royalties and license fees
Regular import – non dutiable components separated

<table>
<thead>
<tr>
<th>Value drivers</th>
<th>Full Royalty</th>
<th>Dutiable Royalty</th>
</tr>
</thead>
<tbody>
<tr>
<td>Manufacturing knowhow</td>
<td>2</td>
<td></td>
</tr>
<tr>
<td>Patents</td>
<td>2</td>
<td></td>
</tr>
<tr>
<td>Designs</td>
<td>2</td>
<td></td>
</tr>
<tr>
<td>Trademarks</td>
<td>2</td>
<td></td>
</tr>
<tr>
<td>Copyrights</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>Market research</td>
<td>3</td>
<td></td>
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<tr>
<td>Customer loyalty</td>
<td>3</td>
<td></td>
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<tr>
<td>Strategic planning</td>
<td>3</td>
<td></td>
</tr>
<tr>
<td>Marketing communications</td>
<td>2</td>
<td></td>
</tr>
</tbody>
</table>

Indicative example!

- Customs value:
  - Cost (supplier’s invoice): 100
  - Royalties/License fees: 20
  - Customs Value: 120
  - Customs duty @10%: 12

- Full Dutiable Royalty:
  - 100 Cost (supplier’s invoice)
  - 20 Royalties/License fees
  - 12 Customs duty @10%

- Non Dutiable:
  - 109 Customs Value
  - 10.9 Customs duty @10%

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Links between Transfer pricing and customs

► Separate trading co. (case study 1):
  ► Need to have substance;
  ► Taking title and risk (including inventory);
  ► Sales at arms’ length;

► Royalty bifurcation (case study 2):
  ► Valuation of different elements;
  ► Benchmarking;
  ► Top down or bottom up approach;
Take Aways
Take Aways

BEPS and the Increased Importance of Functional analysis

1. Shift from legal form to economic reality of transaction
2. More thorough functional analysis
3. More focus on risk analysis
4. Re allocation risk possible

This will have to be reflected in TP documentation report.