
**Tuesday, August 29**

**Plenary Session Subject 2: The future of Transfer Pricing**

**General Reporter:** Sergio André Rocha (Brazil)

**Chair:** Luís Eduardo Schoueri (Brazil)

**Panel Speakers:** Yariv Brauner (USA), Richard Vann (Australia), Isabel Verlinden (Belgium), Natalia Quiñones (Colombia), Jefferson Vanderwolk (OECD)

**Secretary:** Mateus Calicchio Barbosa (Brazil)

The second plenary panel delved into alternate simplified approaches (including the formulary apportionment) to deal with the future of transfer pricing (TP) but the audience poll reflected that majority still believe that arm's length will stay as the future of TP. The panel delved into several key transfer pricing issues from intangibles to value creation and from BEPS to formulary apportionment and lastly the disputes resolution.


<u>Consolidated corporate tax base in the European Union</u>

The Panel explained that the European Commission (EC) has decided to re-launch the common consolidated corporate tax base (CCCTB) project in a two-step approach, with the publication of two new interconnected proposals published in 2016 on a common corporate tax base (CCTB) and a common consolidated corporate tax base (CCCTB). It was stated that CCTB are standard rules to calculate taxable result with allocation based on traditional rules, while CCCTB refer to tax adjusted profits from individual accounts aggregated in each operating jurisdiction.

The Panel stated that the European Commission claims that almost 70% of profit shifting would be eliminated and the administrative burden of the compliance costs (different tax jurisdictions in the EU and TP rules) would be reduced by 8%. However, it was highlighted that some of the issues that persist are geographical scope (e.g. inter-company transactions with third-countries would still be subject to TP rules) and the question whether all parties would agree on one single formula. Another pressure point that was highlighted is that CCCTB is unconnected to actual value creation. However, it was stated that the Estonian Council Presidency perceives CCCTB as a tool to tackle the tax challenges linked to digital economy as the virtual PE concept can be implemented with the apportionment formula.

*Robust alternate proxies and information*

The panel highlighted that availability of the 'information' is central to transfer pricing analysis. **Mr. Richard Vann** pointed that the word 'information' appears over 600 times in both the OECD and UN guidance. He however added that there is a lot of asymmetry in the information for the transfer pricing analysis. He stressed that "*In transfer pricing, we are taxing value creation which we cannot observe. We therefore need to find robust and reliable proxies. We instead use CUPs which cannot be found or risk which cannot be observed.*"

<u>BEPS</u>

**Mr. Jefferson Vanderwolk (Head of the Tax Treaty, Transfer Pricing and Financial Transactions Division at the OECD Centre for Tax Policy and Administration)** highlighted the following key changes as a result of the BEPS project:

- Conduct of parties overrides contract terms, if inconsistent.
- Six-step analysis of risk assumption.
- Decision-making function is key and hopefully, decision making would be a more observable parameter.
- Occasional Board meetings to ratify pre-cooked plans (i.e. Rubber-stamping decisions made by others will not suffice).
- Mere legal ownership without performance of relevant functions regarding use and risk control will justify no more than a risk-free return.

He therefore stated that BEPS Actions 8-10 are pushing transfer pricing to a greater reality.

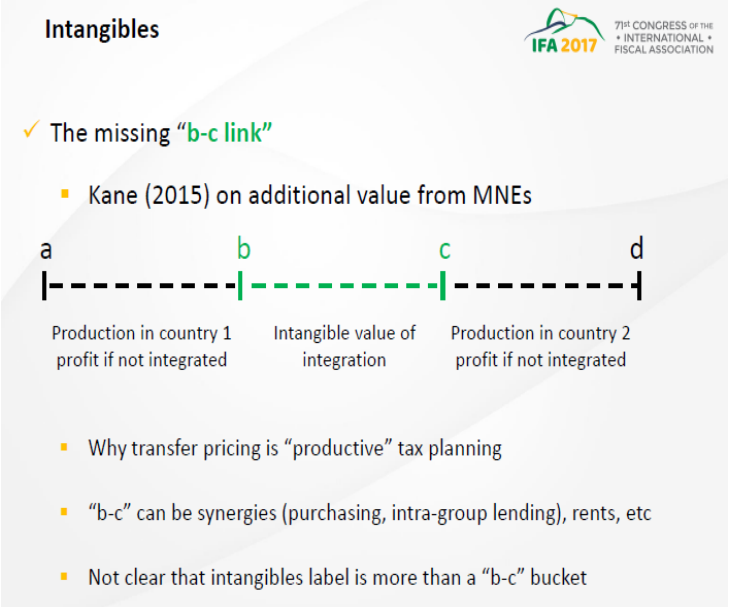
The key pillar of the BEPS process, he stressed, is that profit would be aligned with value creation in accordance with the arm's length standard. On the question, as to where profits should be allocated and which countries should be entitled to tax those profits, the Panel expressed their concern that "*We don't know what creates value and hence, each country will try to claim that value drivers reside within their country*."

Another audience poll "*Have BEPS' TP Recommendations reached the core issues for the future of transfer pricing?*" was answered in negative by an overwhelming majority.


Intangibles

The panel then discussed about various aspects of intangibles such as identification, ownership, risk, valuation etc. **Mr. Richard Vann** pointed out that the 'b-c' link (refer to the side diagram) is a key to value creation of the MNCs.

Regarding TP-issues on intangibles, **Mr. Richard Vann** quipped *"Down in the DEMPE dumps"* and cited from OECD TP Guidelines (TPG, 6.56) that "*these more important functions may include, among others, design and control of research and marketing programmes, direction of and establishing priorities for creative undertakings including determining the course of 'bluesky' research, control over strategic decisions regarding intangible development programmes, and management and control of budgets"*. He also raised a thought-provoking question to the audience that if R&D is seen as central to modern MNE, then where are the people i.e. researchers?




**Mr. Richard Vann** expressed that current proxies used in the transfer pricing analysis like CUP or databases have limitations. He reiterated that all the proxies that we can be manipulated and that risk is becoming just another name for 'function'. Explaining the network effect which has long been recognized as a source of monopoly profit, **Mr Vann** expressed that "*Too often the activity of the developer of IP which has turned out to be dominant after the operation of the network effect is seen as the source of the profit but it is the network, as much as, or more than the development `activity*". It was also stated that US has not applied much hind-sight approach in intangibles in the past.

Main issues of current TP regime

*Confidentiality*

The Panel stressed that tax administration must ensure confidentiality of information like trade secrets, scientific secrets, commercially sensitive information etc. in the documentation package. However, it was highlighted that the big 'game changer' is that public image of MNEs and their financial reputation is at stake. It was also stated that NGOs which are for tax transparency claim that making the Country by country (CbC) reports public will shift part of the workload of tax administrations to the public in a "crowd sourcing" model.

*Value creation*

Regarding value creation, it was explained that value is reflected in market and most valuable businesses today develop and exploit unique intangibles globally. It was further elaborated that internet based businesses take advantage of low-cost infrastructure, and gather vast amounts of user information free of charge and as intangibles have no physical location, it poses a challenge for territorial based taxation.

Majority from the audience answered the poll 'Is the future of transfer pricing all about assets, functions and risks?' in the negative. **Mr. Richard Vann** added that perhaps flexible profit split based on observable and non-manipulative criteria would be the future of transfer pricing. He suggested an evolutionary solution as the most likely way to move forward i.e. remain within the arm's length standard but deal with the major problems.

Alternatives and perspectives for the future

The panel then discussed safe harbours as one of the approaches to deal with transfer pricing issues. The panel also discussed pros and cons of formulary apportionment, stating that "*It is perhaps direct solution to the division of tax base and may bring transparency, simplicity and efficient.*" It was also stated that CbCR could be a door opener for the formulary apportionment though current rules preserve the arm's length rhetoric.

Touching upon the non-arm's length standard solution, the Panel agreed that corporate residence taxation is not the solution. It was explained that it has been often suggested in US that ending deferral (along with other tweaks in the system) will solve the transfer pricing problem. However, it was highlighted that such approach only deals with transfer pricing out of that country and makes sense if most of the shareholders are resident in the same country though it does not solve division of revenue between other source countries. For e.g. US MNC investing into Australia via Singapore, the TP problem is more relevant for profit allocation between Singapore and Australia and not US.

The Panel then discussed about the sixth method which was created to facilitate TP audits for commodities to standardize pricing based on international public indexes. However, it was highlighted that there were several problems in practice such as adjustments due to quality, logistics, differences in production costs or who chooses the index, or the timing issues.


The Panel also discussed about judges evaluating very delicate issues on transfer pricing such as intangibles. The suggestion was that to consider international tax courts, which to begin with can deal with transfer pricing. It was felt that sovereignty concerns are relatively lesser compared to other tax areas since TP essentially involves determination of the facts, which can be evaluated by such international court.

It was also urged that the time had come for developing countries to adopt Brazil like situations of simplified approach instead of importing complex TP methodologies. **Mr Jefferson Vanderwolk (OECD)** concluded the session by remarking that *"as long business is free to innovate and sell, Government will ultimately find balance to tax it without killing it! Not worried about lack of magic bullets."*

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**DTS & Associates Take:**

As regards India's TP litigation landscape, the developments around this subject are vindicating the approach taken by Indian Revenue Authorities to protect the tax base. Few of the challenges which were faced by companies operating only in India, are now perceived globally which they would have to reconcile therewith. One of the key factors now is not the contract signed between Associated Enterprises, but the conduct of the parties to determine the jurisdiction for taxing value creation.


**Seminar C: Cost-sharing and Cost Contribution Arrangements**

**Chair:** Sam Maruca (USA)

**Panel Speakers:** Lauren Ross (USA), David Rosenbloom (USA), Marlies De Ruiter (Netherlands), Graeme Cooper (Australia), Luciana Galhardo (Brazil)

**Secretary** : Lauren Ann ross

The theme of the technical session was to discuss the future of cost contribution arrangements (CCAs) with the special focus on whether CCAs will remain a viable planning vehicle, considering the impact of the OECD's Base Erosion and Profit Shifting (BEPS) project. The panel noted that CCAs are used by multinational enterprises to pool resources and share risks incurred in developing tangible and intangible assets or in the performance of services. The panel discussed about the benefits, contributions, entry and termination of CCAs. Different country perspectives were also discussed during the panel.


In the context of Brazil, **Luciana Galhardo** shared that, based on the judicial precedents, the validity of CCAs depends on the following criteria -

- clearly formulated arrangements;
- clear criteria for measuring the cost-benefit and detailed description of costs incurred;
- application of the arrangement with uniformity and consistency;
- shared activities should be booked according to the generally accepted accounting principles;
- reimbursement of expenses by debit notes;
- the activities covered by arrangement cannot be part of the core activities (back-office only); and

- the cost sharing arrangement should not involve any type of remuneration, price or profit margin.

Further, she noted that it is not very common in Brazil to have CCAs relating to R&D expenses. Sub-contracting third parties, qualification of reimbursements as services and definition of "core / non-core" activities were identified as some of the key issues from Brazilian perspective relating to the CCAs.

In the context of Australia, the panel noted that the cost sharing arrangements are common and observed that the guidelines are issued by the Australian Taxation Office (ATO) on the CCAs. **Mr Graeme Cooper** referred to Australian Guidance (TR 2004/1) which states that ATO will not respect terms of the CCA unless the '*arrangement makes business sense' and 'accord with economic substance.*

Responding on the need and relevance of the Chapter 8 to the revised OECD TP Guidelines, **Ms Marlies De Ruiter (former Head of Transfer Pricing at OECD)** stated that these were needed to rebut pre-notions and to clarify what the guidance shouldn't be. Sharing the Dutch perspective, she added that guidance in Netherlands on CCAs is in line with post-BEPS scenarios.

In the USA context, **Mr David Rosenbloom** stated that the term 'CCA' has a unique meaning compared to the other jurisdictions. USA refers to the term 'cost sharing' in the context of mainly the intellectual property (IP) development. Thus, an agreement to share the cost of services is not part of CCAs. He further stated that the OECD TP guidelines are also not referred to in USA since there are separate guidelines. The panelist also mentioned that there was a court ruling in USA relying on the OECD guidelines in this respect, but he could not recall the name.

Since most CCAs involve around the development of intangible assets, **Mr Rosenbloom** also discussed the definition of intangible assets under the US IRS regulations. It was stated that definition of intangibles in the US guidelines is narrower in scope and leaves out intangibles such as goodwill, going concern value, workforce in place, residual value from the scope of the definition.

The panel noted major issues for CCAs viz. i) the expected benefits commensurate with contributions? ii) appropriate cost pool for cost sharing? **Mr Rosenbloom** cited stock option costs as a key example on the second issue of "cost pool". It was argued that cost pool is much lower if stock option costs are excluded, which is an important element in the context of technology sector in USA. **Mr Rosenbloom** criticized IRS approach in this regard. He added

that the near-term future in USA revolves around cost sharing and cited ongoing cases involving Facebook and Microsoft in this context.

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**Seminar D: Advanced Pricing Agreements and International Tax Impacts**

**Chair:** Bruno Gibert (France)

**Panel Speakers:** Shefali Goradia (India), Matthew Frank (USA), Max Lienemeyer (EU), Monika Laskowska (Poland), Yuko Miyazaki (Japan)

**Secretary:** Céline Pasquier (France)


The panel on Future of APAs, especially in light of EU State Aid actions, witnessed an engrossing 100 minutes discussion, as the panelists put some searching questions to EU representative Max Lienemeyer.

<u>European Commission & APAs:</u>

Mr. Lienemeyer set the stage for the discussion, by taking the panel and the delegates through the work being done by European Commission (EC), the objective and rationale for the rulings it has passed in high profile cases like Starbucks, Apple, Fiat etc. He told the audience that the aim of EU State Aid is to protect internal market against distortions created by member states. Referring to the Starbucks case, he shared that the Netherlands subsidiary of the MNC giant, that was the only coffee roasting company of the group in Europe, was paying substantial royalty to a UK based company of Starbucks group for coffee roasting know how and in the process, was reporting too little profits in the Netherlands. The Commission's investigation established that the royalty paid by Starbucks Manufacturing to Starbucks UK entity cannot be justified as it does not adequately reflect market value.

Of the 300 cases in which the European Commission (EC) is presently engaged in fact finding, Mr. Lienemeyer talked about the 3 big cases pending before EU State Aid - Amazon, McDonalds & GDF Suez (all to do with tax benefits in Luxembourg and they concern APAs but also other advance tax rulings). He opined that there is unlikely to be State Aid if OECD Transfer Pricing Guidelines are compiled with, and added that the Commission's focus is on cases where there is a manifest breach of the ALP. He also asserted that merely signing an

APA, did not amount to providing State Aid, that every case is judged on its own merits and the focus of the Commission is on 'outliers.' Peppered with questions from fellow panelists, Mr. Lienemeyer clarified the following as regards EC's position vis-a-vis APAs:


1. APA provides EC with tax information but at the same time tax rulings are like a 'dark alley', not 'street lights.' He added for good measure that at times even Transfer Pricing reports aren't available while scrutinising APAs.

2. The EC is unlikely to have an objection to APAs that shed some 'light.'

3. Rebutting any talk of 2 Arms Length Standards, Mr. Lienemeyer firmly stated that "We have only one Arms Length Principle (ALP) but we have a different origin from OECD. There is not separate EU ALP".

4. The EC does not have any bias against US cos and is looking at non-US cases too. Eg. - Fiat.

Mr. Lienemeyer batted for Public CbCR, terming it "useful."

APA Publication Practices:

The panelists then enlightened the audience on the APA publication practices in different countries, with most of them sharing publicly only the high level statistics on the APAs signed. Ms. Miyazaki stated that confidentiality is an essential aspect of APA program in Japan. Mr. Frank then livened up the proceedings by making the arguments in favour of as well as against greater disclosure of APAs. On balance, he opined that the human nature is to be wary when the spotlight is on you and hence making APAs public, might deter the IRS officers from taking positions and signing APAs. Mr. Lienemeyer countered this argument, saying that the tax authorities should stand by their decisions and not hide behind the cover of secrecy.

Future of APAs:

The panel discussed the boom in MAP cases, which have multiplied by 2.5 times in last 10 years and increased 30% in last 2 years. They also discussed the future viability of APAs considering the new options of dispute resolution - Arbitration & Mediation. Mr. Frank quipped that Unilateral APAs are becoming a 'dirty' word and there is now a push for Bilateral/Multilateral APAs. When the question was posed to the audience though, an overwhelming majority raised their hands to say that APAs are here to stay!! Ms. Monika Laskowska then discussed the 4 areas of likely interest wherein APAs might be in demand:


- Intangible related transaction

- Profit Split Method (aligned with Value Creation)

- Group Synergy

- Profit Attribution to PE

A case study of a French pharmaceutical company acting as entrepreneur principal with subsidiaries in US (R&D), India (manufacturing), Japan (distributor) and Poland (support services) was presented. Ms. Shefali Goradia shared that preference of all countries was to go for bilateral or multilateral APA to get certainty especially given the significance of intangible. The APA teams are centralized in all countries, notably in the US, tax audit team is a part of the APA team. Ms. Goradia added that in France and India, taxpayer is required to give information about APAs signed with other countries. Generally, countries don't cover confirmation on 'no PE' in the APA though there is a growing need for it and in practice, Poland and France do include that.

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**DTS & Associates Take:**

We witnessed a fantastic session where Mr. Lienemeyer (EU Commission) summarized the way they are approaching and dealing with all the cases identified and ruled upon. There is a lot to learn for every country (including developing economies) from the EU Commission rulings against the taxpayers viz. Starbucks and McDonald's which involve large stakes. While some may perceive the State Aid as a threat to APAs, but truth of the matter is, they will go hand in hand. The APAs are going to be an important tool when it comes to elimination of double taxation which is likely to arise from rapid implementation of BEPS by the countries.