

BEPS In Action

32nd Annual TEI-SJSU High Technology Tax Institute

10:20am – 12:00pm Monday, November 7, 2016

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Topics

1. Existence of PE
2. Transfer Pricing
3. Attribution of Profits
4. Hybrid Rules
5. Treaty Issues

Questions are welcome at all times!

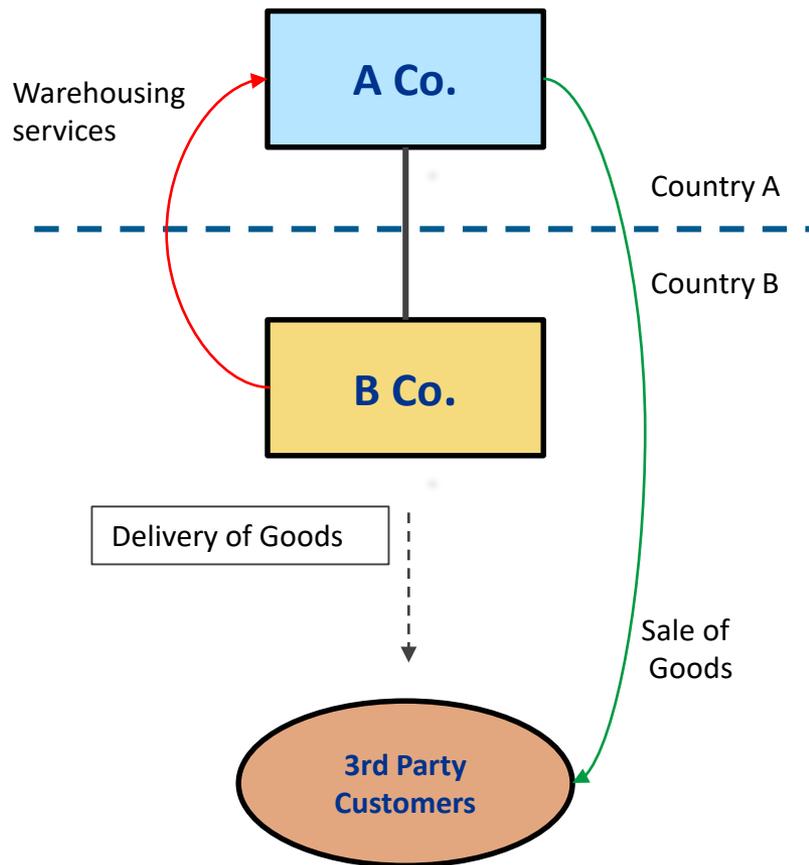
1. EXISTENCE OF PE

Jim Carr

OECD BEPS Action 7 (PE)

Specific Activity Exemptions

Article 5.4



- B Co provides warehousing services to A Co
- A Co sells goods to Customers delivered from B Co's warehouse

Key Considerations:

- Does A Co have a fixed place of business (or dependent agent) in Country B? If not, para 4 is inapplicable
- If B Co does have a FPB, does the warehousing activity satisfy the new preparatory and auxiliary threshold?
 - Paragraph 22 of the Final Report commentary would provide for the possible existence of a PE when a taxpayer maintains a large warehouse with a significant number of employees.
- Anti-fragmentation could require considering both companies' operations in applying exemptions.

OECD BEPS Action 7 (PE)

Dependent Agent PE

Article 5.5

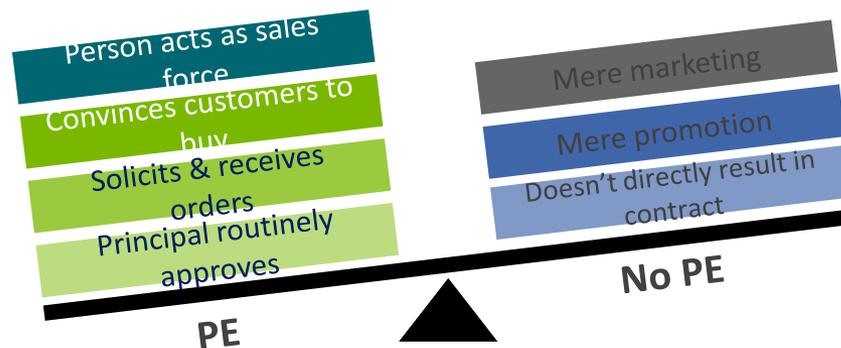
Notwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph 6, where a person is acting in a Contracting State on behalf of an enterprise and, in doing so, habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise , and these contracts are

a) in the name of the enterprise, or

b) for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or

c) for the provision of services by that enterprise,

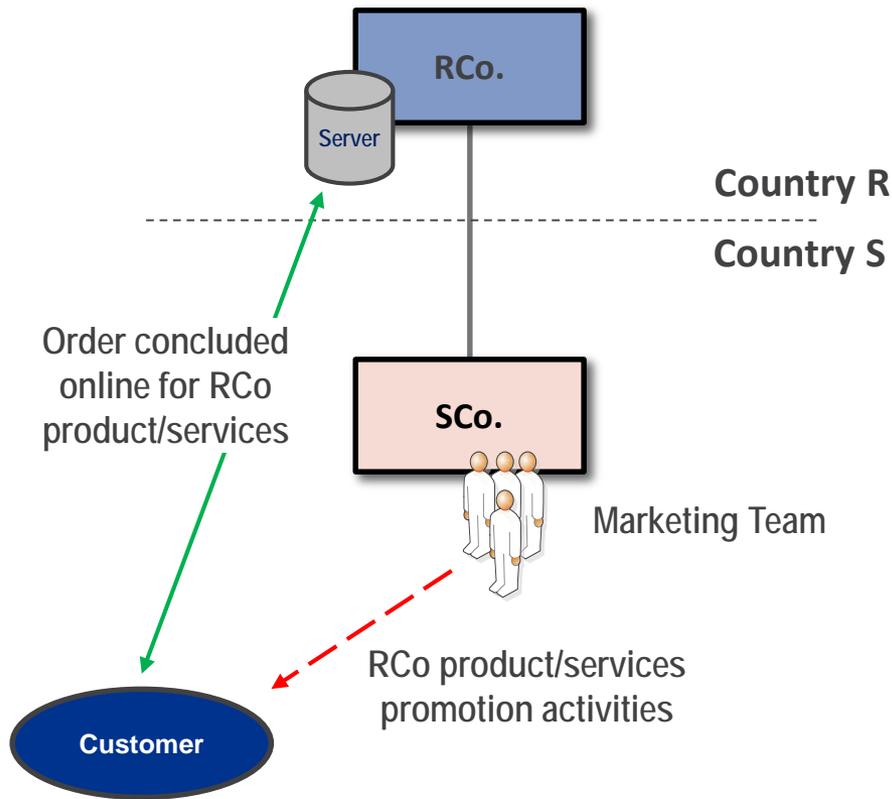
that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes [unless such activities would be exempt under paragraph 4].



OECD BEPS Action 7 (PE)

Customer-Facing PE

Art 5.5(b) Illustration (para 32.6)



Description

- RCo (State R resident), distributes products and services through its websites. RCo owns SCo (State S resident)
- SCo's employees promote RCo's products and services. Their remuneration is partially based on revenues derived by RCo from holders of S's accounts
- When an account holder agrees to purchase goods promoted by an SCo employee, the employee indicates the price that will be payable and that the contract must be concluded online with RCo, and explains the standard terms of RCo's contracts. The employee cannot modify these terms

Results

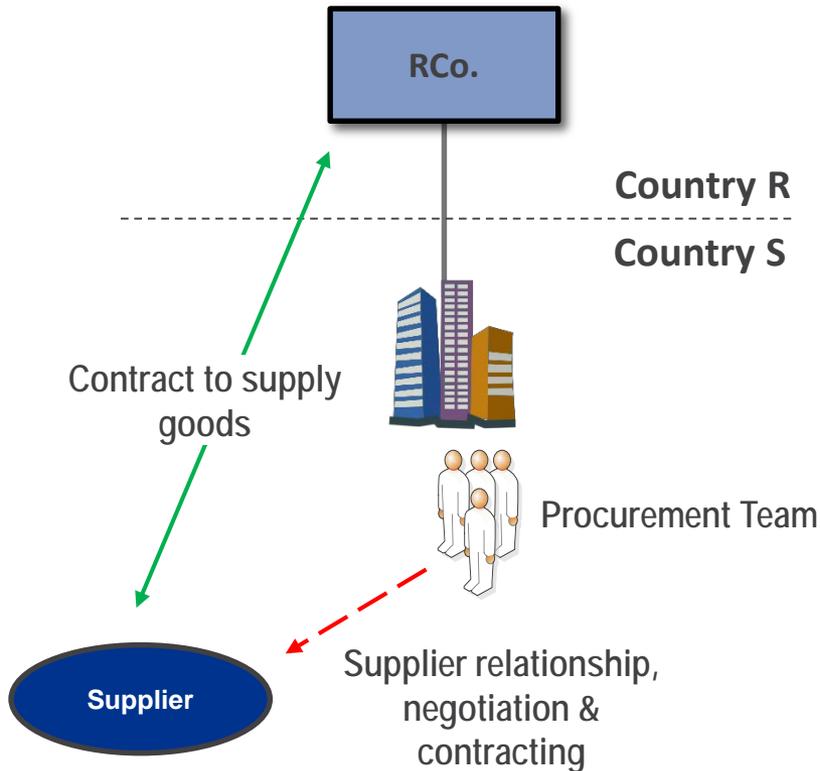
- SCo's employees play the principal role leading to the conclusion of the contracts routinely approved by RCo without modification

“The fact that SCo’s employees cannot vary the terms of the contracts does not mean that the conclusion of the contracts is not the direct result of the activities that they perform on behalf of the enterprise, convincing the account holder to accept these standard terms being the crucial element leading to the conclusion of the contracts between the account holder and RCo.” *Proposed commentary on Art 5.5 (Para 32.6)*

OECD BEPS Action 7 (PE)

Supplier-Facing PE

Art 5.5(b) Illustration (para 32.2)



Description

RCO sources products from Country S that it then distributes from Country R. RCO's Country S employees are experienced buyers and negotiate and enter into supply contracts for RCO

Results

- RCO has a Country S PE. “. . . although [RCO's Country S purchasing activity] is an activity covered by subparagraph d) [(a specified exception to a fixed place of business PE), the exception] does not apply and the office therefore constitutes a PE because the purchasing functions form an essential and significant part of RCO's overall activity.” *Proposed commentary on Art 5.4 (Para 22.5)*

Queries

1. What if Country S employees were employed by SCO (rather than RCO)? Could RCO have a dependent agent PE under Art 5.5?

“Where, for example, a person acts solely as a buying agent for an enterprise and, in doing so, habitually concludes purchase contracts in the name of that enterprise, paragraph 5 will not apply [i.e., no PE] even if that person is not independent of the enterprise *as long as such activities are preparatory or auxiliary* (see paragraph 22.5 above).” *Proposed commentary on Art 5.5 (Para 32.2)*

2. Does the scope of Art. 5.5 include ‘buy-side’ contracts?

“The contracts referred to in Art 5.5 cover contracts relating to operations which constitute the business proper of the enterprise.” *Proposed commentary on Art 5.5 (Para 33)*

Taxpayer Responses To Manage Risk

- Stay on safe side of “convincing” vs. “marketing” line
- Rely on profit attribution rules
- Report a PE, including establishing a branch in market state (possibly converting local sales entity)
- Convert to reseller
 - Commentary language both helpful and troubling
 - clear support for LRD as not creating PE
 - caution that entity must be “distributor”, and not an “agent”
 - caution that entity must acquire and dispose of title so that it “would derive a profit from the sale” and not a “commission”
- APAs and rulings to obtain comfort may become popular

2. TRANSFER PRICING

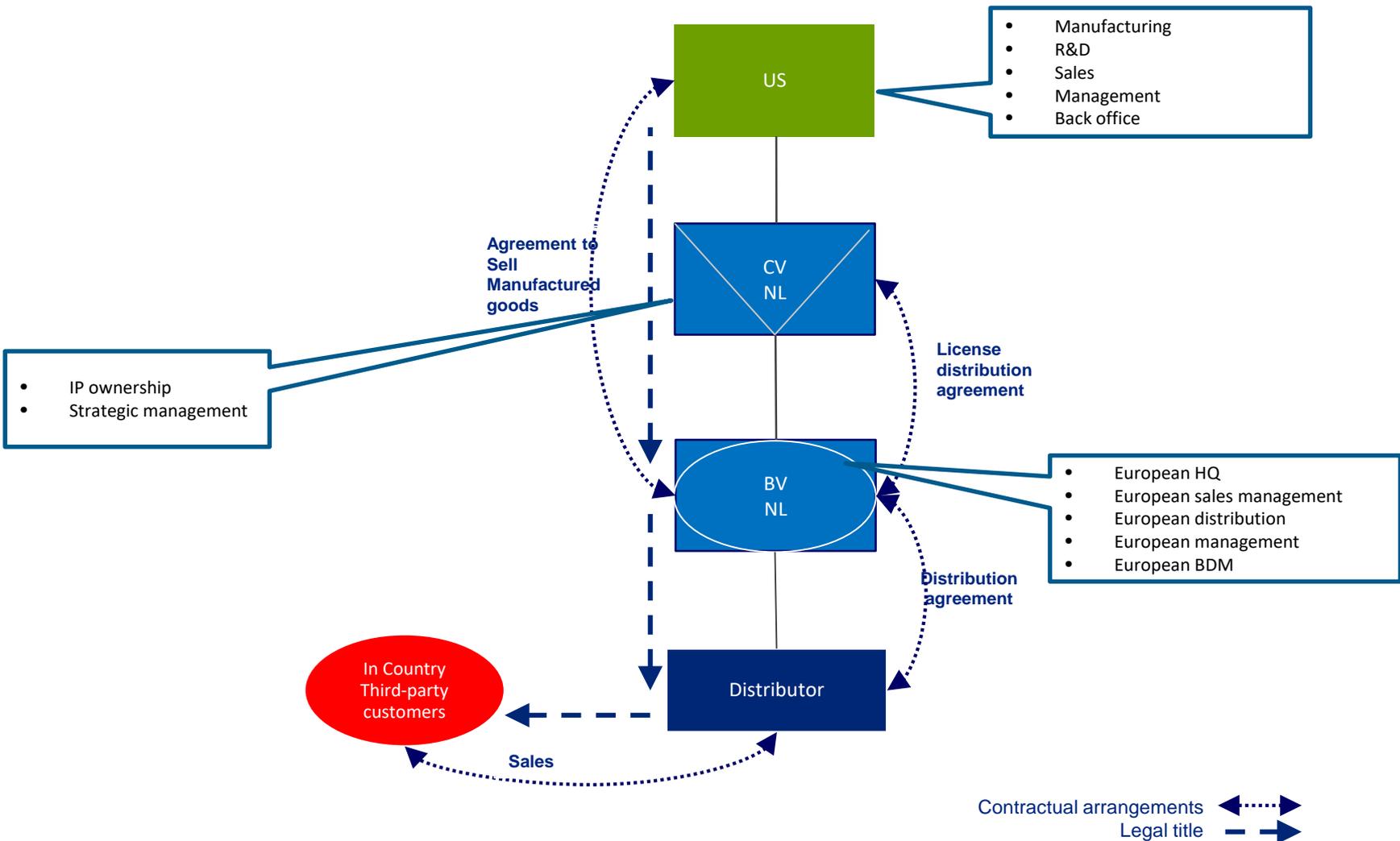
**BEPS: ACTION ITEMS 8-10:
ALIGNING TRANSFER PRICING
OUTCOMES WITH VALUE CREATION**

Michael F. Patton

Key BEPS Outcomes Relevant to Transfer Pricing Analysis

- According to the Final Report for Actions Items 8-10, traditional transfer pricing has failed to emphasize economic value creation and instead has emphasized contractual terms instead of economic substance in two significant areas:
 - Ownership of intangibles, especially through cost sharing (a/k/a cost contribution arrangements);
 - Allocation (limitation) of risks
- Cost Sharing Post BEPS
 - IP ownership through cost sharing will only be recognized if the cost sharing party (IP Co) exercises or manages DEMPE functions.
 - Development, Enhancement, Management, Protection or Exploitation of the cost-shared IP
 - “Cash Box” IP Co’s are only entitled to a limited return on capital.
- Risk allocations (e.g., limited risk distributors, contract manufacturers, etc.) are only respected if
 - The actual conduct of the parties is consistent with the allocation of risks. Management of the factors affecting the outcome of the risk is critical.
 - The party assigned a risk has the financial ability to bear the risk.

Principal Operating Company (POC) Example – Dutch CV/BV



Increased Transfer Pricing Risks for Local Op Cos

European Union

- State aid investigations
- Sharing of rulings
- Commission's "fight against tax avoidance"

OECD BEPS

- Transfer pricing (intangibles and Ch.1 focus on functions)
- Permanent establishments (changes to Art.5)
- Generated greater awareness of international tax/TP issues

Political and Social

- Political pressure on companies and tax administrations
- NGO scrutiny and reputational risk
- Budgetary pressures

Tax Administration Capacity

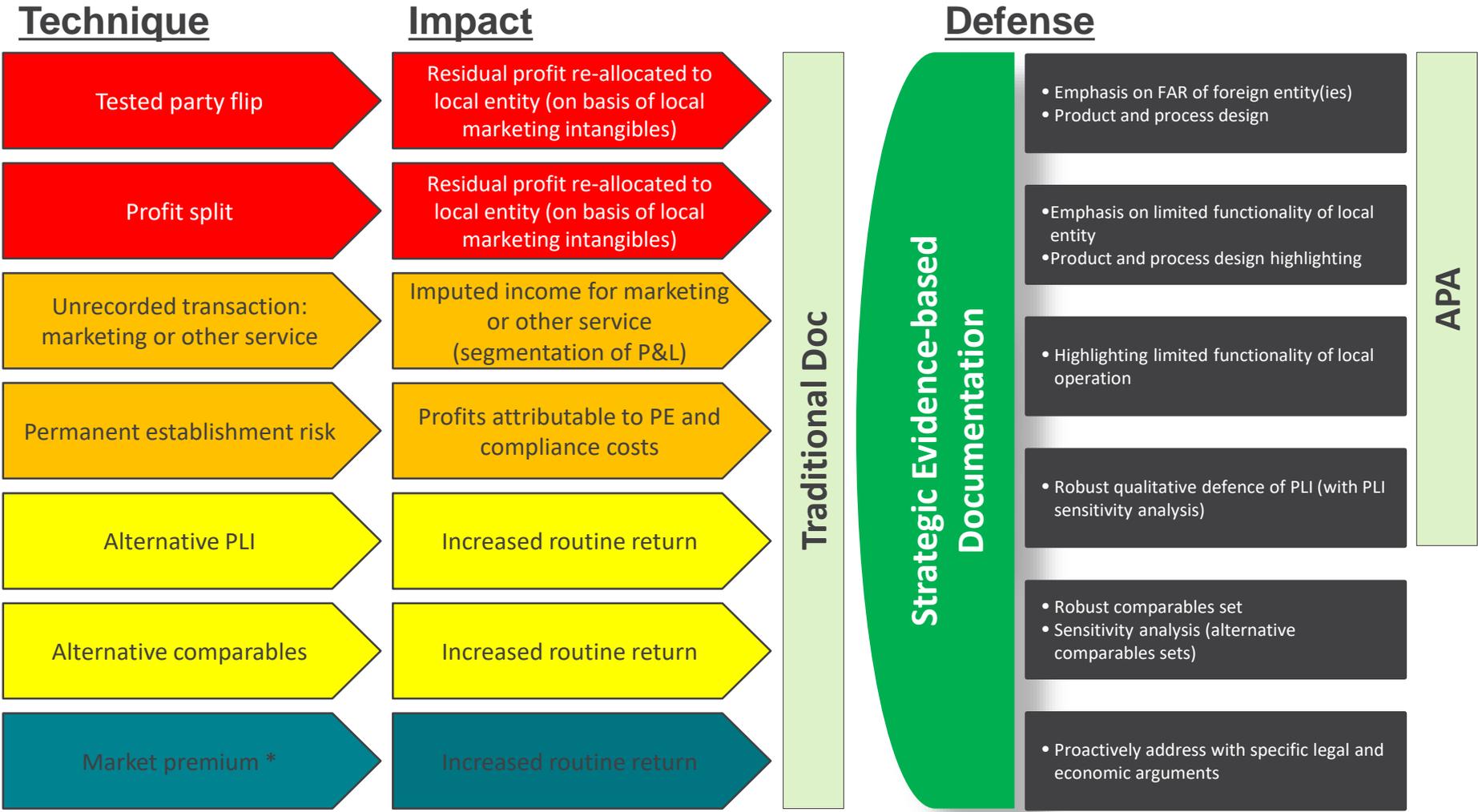
- Better tools (exchange of information, CBC, TP doc)
- Greater cooperation, communication and experience sharing
- Investments in international tax/transfer pricing capacity
- Deeper (more targeted) audits, with extensive fact finding

Greater Scrutiny of local OP Co's in POC structures:

- Distribution
- Manufacturing
- Service providers



Transfer Pricing Exam Risk Examples (Distribution)



Traditional Doc

APA

* Country specific

Key Conclusions

- The tax landscape for POC's is changing and the end state is not certain
- MNC's need to navigate through the changes and determine strategy and priorities
- Evaluating the results of CbC reporting is one of the top priorities for MNC's with a POC structure
- In addition (also within the EU) a strong push for increased transparency and sharing of information between taxing authorities is imminent
- Evaluating the revised TP guidelines on intangibles and risk allocations are crucial
- EU developments should be monitored closely as they could accelerate or supersede BEPS initiatives
- MNC's need to evaluate how effective are Dispute Resolution and MAP procedures under their current structures and TP policies
- APA's are still available to reduce risk in key jurisdictions, but value and risks of APA need to be assessed, especially in light of State Aid cases.
 - Unilateral APAs need to be approached with caution.

3. CONTRIBUTION OF PROFITS

Gary Sprague

Work on Attribution of Profits – Status

- MLI text available shortly
 - no Art. 7 changes expected
- Profit attribution Discussion Draft
 - released July 4
 - consultation Oct. 11
- Possibly DD #2 to come?

DD Examples

- Four on sales focused activity
 1. sales agent activity
 - no profit attributed
 2. looks like a commissionaire
 - inventory funding risk attributed
 3. travelling sales person (no in country entity)
 - credit risk, inventory risk and use of asset (car) attributed
 4. complex allocation of credit / bad debt functions
 - allocation split between dependent agent enterprise and PE

DD Examples (continued)

- Three dealing with warehouses
 1. warehousing services provided to third parties
 - attributes economic ownership of warehouse asset and functions on premises
 2. warehouses own goods
 - also attributes economic ownership of warehouse asset and functions on premises
 3. warehouse owned by enterprise but operated by unrelated entity
 - attributes only economic ownership of the asset

Major Issues Raised by the Examples

- Application of risk allocation under Art. 9 per revised TPG Ch. I
- Art. 7 vs. 9 interaction
- Identification of “significant people functions”
- Definition of “dealings” to set the hypothetical transfer price
- Administratively convenient approaches in cases of low or nil attribution

Reliance Issues for Taxpayers

- Scope of relevant treaties
 - 2008 vs 2010 Authorized OECD Approach (“AOA”)
- Country acceptance not so great at the moment
- No treatment of marketing intangibles
- How to claim losses in PE

Prognosis for Future

- Possible revised DD
- Possible “Plan B”
- Any effect on decision by countries to sign MLI?
- Action 1 PE possibilities connected with this project?

4. HYBRID RULES

Gabe Gartner

BEPS Action Item 2

- Final Report on Neutralising the Effect of Hybrid Mismatch Arrangements released October 5, 2015
 - Addresses hybrid entities and hybrid instruments
 - Not intended to apply to payments made to an entity resident in a no-tax jurisdiction
- Final Report identifies three categories of “hybrid mismatches”
 - **D/NI** (deduction / no inclusion) – payment is deductible under the rules of the payer jurisdiction but not included in the ordinary income of the payee
 - **DD** (double deduction) – payment gives rise to two deductions in respect of the same payment
 - **Indirect D/NI** (indirect deduction / no inclusion) – payment is deductible under the rules of the payer jurisdiction and is set-off by the payee against a deduction under a hybrid mismatch arrangement
- Discussion Draft on Branch Mismatch Structures released August 22, 2016
 - Addresses payments made by/to a branch that are treated differently by the resident jurisdiction and the branch jurisdiction – and thus result in D/NI or DD

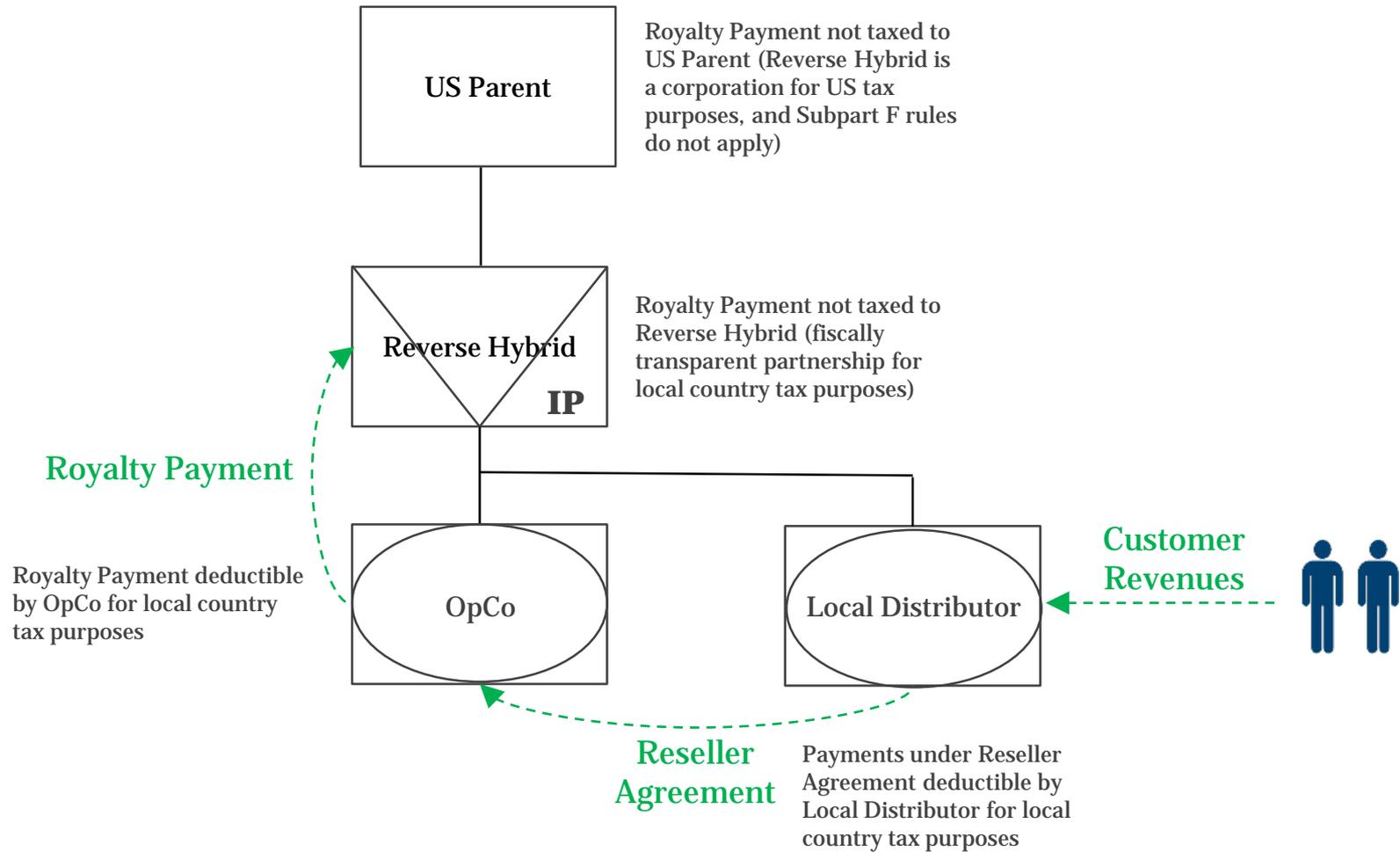
BEPS Action Item 2 (continued)

Hybrid Mismatch	Arrangement	Recommended Hybrid Mismatch Rule		
		Primary Response	Defensive Rule	Scope
D/NI	Hybrid financial instrument	Deny payer deduction	Include as ordinary income	Related parties and structured arrangements
	Disregarded payment made by hybrid	Deny payer deduction	Include as ordinary income	Control group and structured arrangements
	Payment made to reverse hybrid	Deny payer deduction		Control group and structured arrangements
DD	Deductible payment made by hybrid	Deny parent deduction	Deny payer deduction	No limitation on response; defensive rule applies to control group and structured arrangements
	Deductible payment made by dual resident	Deny resident deduction		No limitation on response
Indirect D/NI	Imported mismatch arrangements	Deny payer deduction		Members of control group and structured arrangements

EU Anti-Tax Avoidance Directive

- Anti-Tax Avoidance Directive (ATAD) requires Member States to adopt hybrid rules by December 31, 2018, with effect from January 1, 2019
 - European Commission to draft proposal on hybrid mismatches involving third countries by October, with agreement to be reached by the end of 2016
- ATAD addresses two categories of “hybrid mismatches”
 - D/NI – a deduction of a payment in the Member State in which the payment has its source without a corresponding inclusion for tax purposes of the payment in the other Member State
 - DD – a deduction of the same payment both in the Member State in which the payment has its source and in another Member State
- Hybrid rules under ATAD
 - D/NI – the Member State of the payer will deny the deduction
 - DD – only the Member State in which the payment has its source will permit the deduction

Potential Imported Mismatch in Buy-Sell Model



Key Questions

- Structures subject to hybrid rules
 - Hybrid entities, hybrid instruments, and certain branches
 - Payments made to an entity resident in a no-tax jurisdiction?
- Scope of hybrid rules
 - Imported mismatch rules broadly adopted?
 - Payments covered (*e.g.*, interest, royalties, service charges, and COGS)?
- Timeline for adoption of hybrid rules
 - UK hybrid rules effective January 1, 2017
 - EU Member States to adopt hybrid rules effective January 1, 2019

5. TREATY ISSUES

Adam S. Halpern

Treaty Issues

- Action 6 on preventing inappropriate granting of treaty benefits
 - Requires as a minimum standard that countries include in their treaties:
 - an express statement that their common intention is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including treaty shopping
 - either an LOB rule, a principal purposes test, or both; an LOB rule alone must be supplemented by a mechanism (not necessarily in the treaty) to address conduit financing entities
 - Also includes certain specific new rules on dividend transfer transactions, real property holding companies, dual residents, and exempt permanent establishment issues

Treaty Issues

- Action 14 on making dispute resolution mechanisms more effective
 - Requires as a minimum standard that countries implement treaty MAP obligations in good faith and that cases are resolved in a timely manner
 - Thirty countries have committed in principle to provide for mandatory binding arbitration in their treaties
 - Australia, Austria, Belgium, Canada, France, Germany, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Poland, Slovenia, Spain, Sweden, Switzerland, the U.K., and the U.S.
 - For other countries, enforcement of the minimum standard will depend on peer-based monitoring

Treaty Issues

- Action 15 on developing a multilateral instrument (MLI) to modify bilateral tax treaties
 - Intended to address gap between most recent OECD commentary changes (including BEPS measures) and actual treaties in force
 - Discussion draft released May 31, 2016, numerous comments submitted
 - Anticipated to have flexible structure, including opt-in for mandatory binding arbitration
 - English language text is reported to have been agreed in principle, 2016 WTD 185-1 (Sept. 23, 2016)
 - Expected that English and French language texts will be formally adopted in late November, along with an explanatory statement of how the MLI will interact with bilateral treaties and how arbitration provision will work

Treaty Issues

- Parallel treaty developments
 - 2016 update to US Model Treaty
 - Special tax regimes
 - Expatriated entities
 - Substantially revised LOB rules - triangular provision agreed with Luxembourg, with potentially retroactive effective date
 - Mandatory binding arbitration
 - Subsequent changes in law
 - Changes to Article 5 not included
 - EU challenge to Dutch-Japanese treaty LOB provision
 - cannot grant more favorable treatment to companies owned by Dutch shareholders vs. other EU/EEA shareholders
 - Cannot grant more favorable treatment to companies traded on Dutch stock exchange vs. other EU/EEA stock exchanges
 - Implications for LOB provisions in US treaties

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