



# TRANSFER PRICING

APA, country by country reporting,  
DEMPE, what's new in litigation, and TCJA  
considerations two years later.

TEI-SJSU High Tech Tax Institute

November 4, 2019

<http://www.sjsu.edu/taxinstitute/>

## PANELISTS

**Sharon Heck**: (Moderator) CVP, Treasurer and Chief Tax Officer, Intel Corp.

**Daniela Ielceanu**: Partner, PwC

**Eli Hoory**: Special Counsel (Int'l), Chief Counsel, IRS

**John Hinman**: Director, Field Operations, Treaties and Transfer Pricing Operations, IRS

**Margaret Critzer**: Senior Advisor, Alvarez & Marsal Taxand, LLC

**Matt Kramer**: Managing Director, Grant Thornton

**Vasudha Rangaprasad**: Principal, Deloitte

# AGENDA

SUBJECT	PRESENTERS	DURATION
DEMPE	Daniela Ielceanu	15 minutes
APMA's functional cost diagnostic model (FCDM)	Margaret Critzer, Daniela Ielceanu	10 minutes
Digital tax – connections to TP	Matt Kramer, Vasudha Rangaprasad	30 minutes
Update on litigation	Matt Kramer, Eli Hoory	15 minutes
Transfer Pricing Practice – TCJA and other hot topics	John Hinman, Margaret Critzer	15 minutes



## DEMPE ANALYSIS

# OVERVEIW

1

OECD's view on DEMPE

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How to conduct a DEMPE analysis

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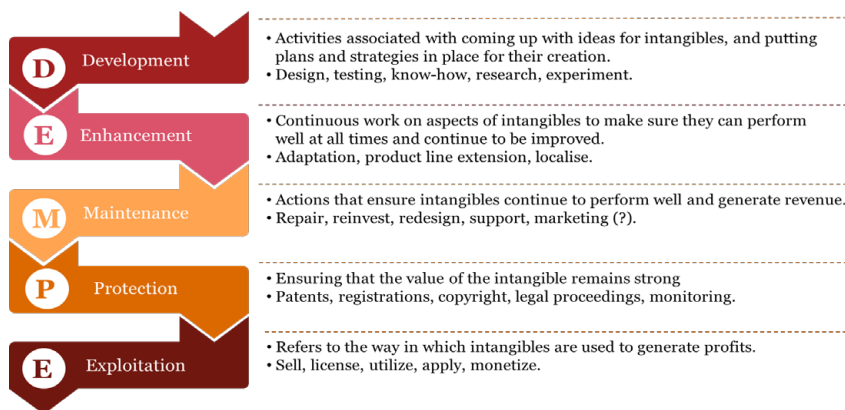
OECD digitalising economy project vs. DEMPE

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Q&A

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## DEMPE – NECESSARY BUT NOT SUFFICIENT?



**July 2017, OECD Guidelines, Para 6.51:** (...) if the legal owner of intangibles is to be entitled ultimately to retain **all of the returns** derived from exploitation of the intangibles it must perform **all** of the functions, contribute **all** assets used and assume **all** risks related to the development, enhancement, maintenance, protection and exploitation of the intangible(...)

**August 2019, Oxford Tax Conference, Pascal Saint Amans:** "DEMPE is nice, [...] it may be killing zero tax jurisdictions, cash boxes, and so, but does not do much of a job."

**October 2019, OECD Secretariat Proposal:** "proposals envisage a new nexus rule that would not depend on physical presence in the user/market jurisdiction."

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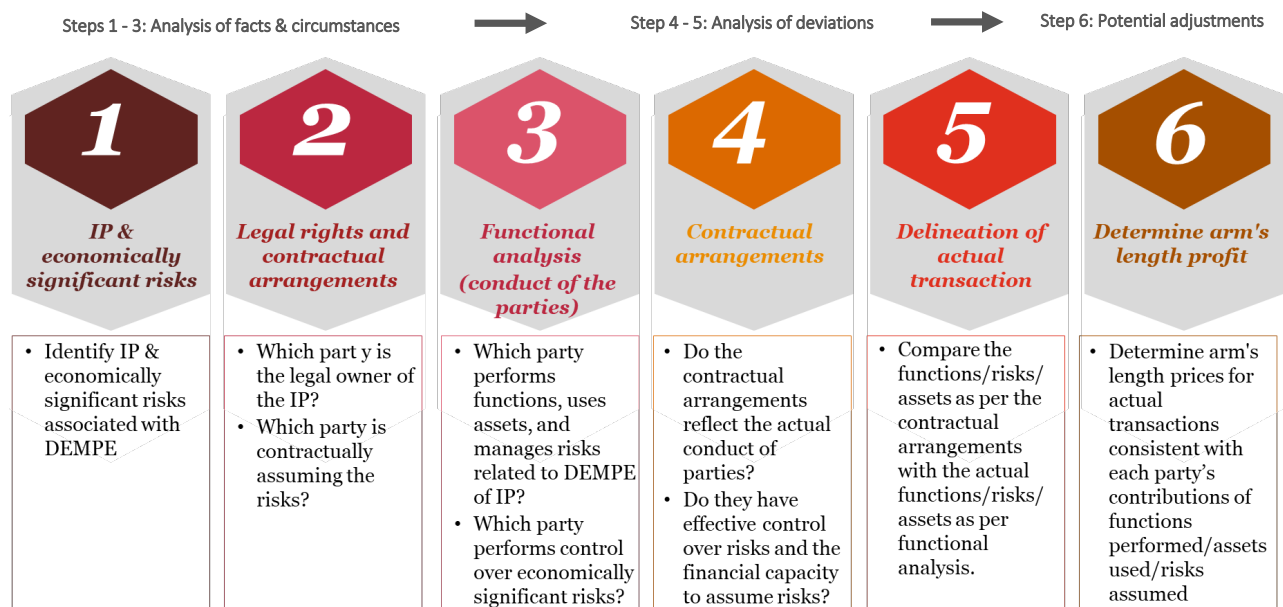
# DEMPE – IT IS ALL ABOUT EXERCISING CONTROL AND ASSUMING AND MANAGING RISK

Source: OECD Guidelines paras 6.49, 6.59, 6.65

Important functions		
For self-developed or acquired intangibles for further development:	For any intangibles:	For purchase of a fully developed intangible:
<ul style="list-style-type: none"> <li>Design and control of research and marketing programmes</li> <li>Direction of and establishing priorities for creative undertakings including determining the course of “blue-sky” research</li> <li>Control over strategic decision regarding intangible development programmes</li> <li>Management and control of budgets</li> </ul>	<ul style="list-style-type: none"> <li>Important decisions regarding defence and protection</li> <li>Ongoing quality control over delegated functions that may have a material effect on the value of intangible</li> </ul>	Key functions performed by purchaser: <ul style="list-style-type: none"> <li>Select the most appropriate intangible on the market</li> <li>Analyse its potential benefits if used by the MNE group</li> <li>Decision to take on the risk-bearing opportunity through purchasing the intangible.</li> </ul>
Assets used		
For self-developed or acquired intangibles for further development:	For any intangibles:	For purchase of a fully developed intangible:
<ul style="list-style-type: none"> <li>Intangibles used in research, development or marketing (e.g. know-how, customer relationships, etc.)</li> <li>Physical assets</li> <li>Funding</li> </ul>		<ul style="list-style-type: none"> <li>Funding</li> </ul>
Risks assumed (controlled)		
<ul style="list-style-type: none"> <li>Risks related to development of intangibles</li> <li>The risk of product obsolescence, including that technological advances of competitors will adversely affect the value of the intangibles;</li> <li>infringement risk, including the risk that defence of intangible rights or defence against other persons’ claims of infringement may prove to be time consuming, costly and/or unavailing;</li> <li>Product liability and similar risks related to products and services based on the intangibles; and</li> <li>Exploitation risks, uncertainties in relation to the returns to be generated by the intangible.</li> </ul>		<ul style="list-style-type: none"> <li>Risks associated with acquiring and exploiting the intangible</li> </ul>

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## DEMPE ANALYSIS – REQUIRES FUNCTIONAL AND RISK ANALYSIS



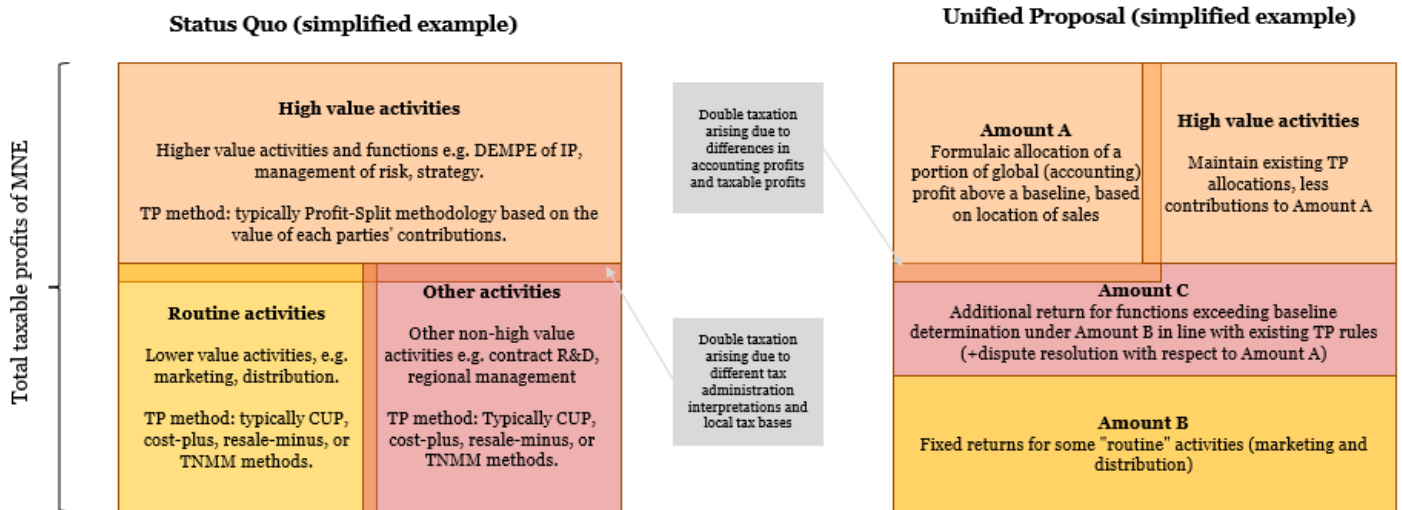
-- Opportunity to identify gaps in DEMPE --

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# PILLAR 1 UNIFIED APPROACH – WHERE DOES DEMPE FIT?

DEMPE still necessary...



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## APMA - FCDM WORKBOOK

# APMA - FCD WORKBOOK

The functional cost diagnostic workbook (the 'FCD') requires the taxpayer to provide financial information for cases where the taxpayer's proposed covered transactions, in light of the taxpayer's business operations, suggest that "material non-benchmarkable contributions" are being made by two or more related parties.

## Steps for completing the workbook

- Identification, organization, and analysis of "functional" costs, i.e., costs incurred by controlled taxpayers in the covered group .
- Analyze the economic contributions associated with functional costs.
- Identify functional costs associated to "routine" functions and that the economic value of such contributions is measurable by reference to third- party benchmarks.
- Identify functional costs that may have an economic value but are not benchmarkable and last beyond a single accounting period. (Up to the taxpayer to consider and identify costs that meet this description)

## Comments

- The workbook will be requested on a case-by-case basis; there is no blanket approach for all the APA requests.
- The FCD includes a "pro-forma" profit split, but APMA's view on whether the profit split method is the "most appropriate" method in the taxpayer's case will be based upon a full analysis of the taxpayer's request in light of the OECD Guidelines
- IRS has stated publicly that enhancements to the model will be coming soon.

## Impact

- The workbook may be requested by APMA in either "inbound" (foreign-parent) or "outbound" (U.S.-parent) cases

## Mitigating risks

- Careful consideration of the costs incurred.
- Documentation of intercompany transactions.
- Re-evaluating the TP Policy

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## TRANSFER PRICING KEY TAKEAWAYS - G20/OECD WORK ON THE DIGITALIZED ECONOMY AND BEYOND

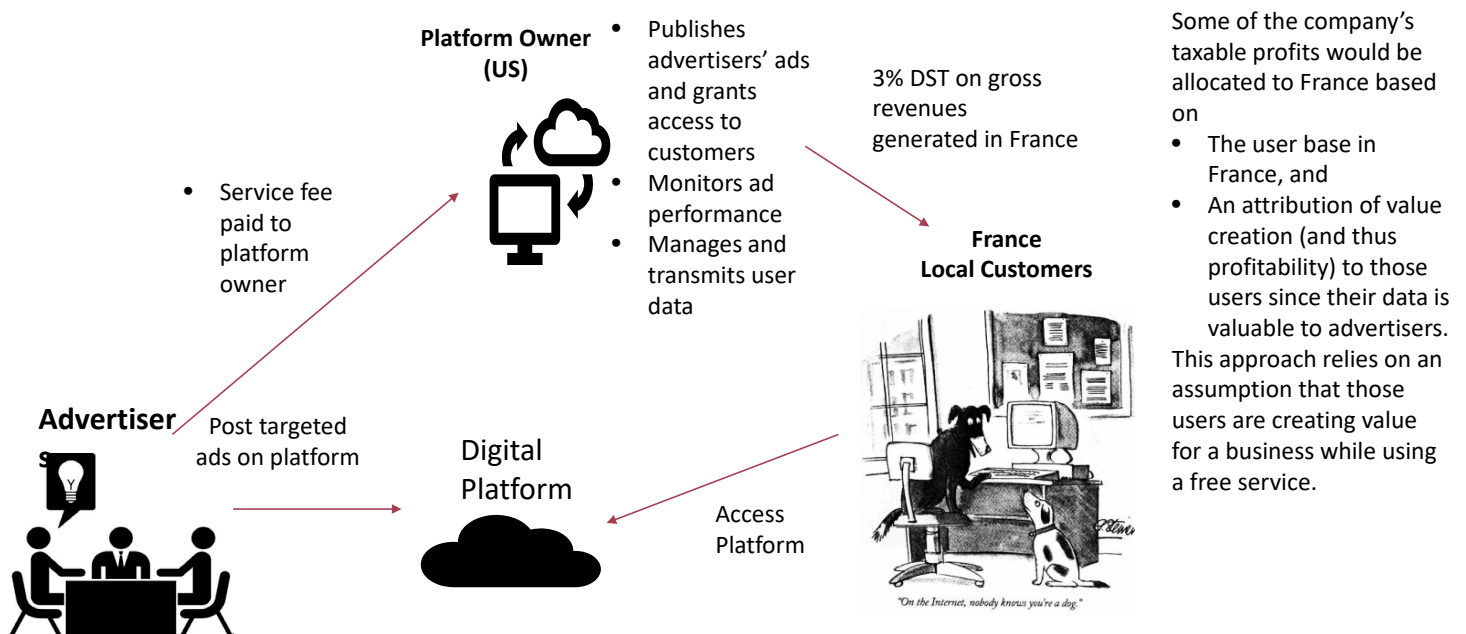
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## BACKGROUND – WHY A DIGITAL TAX?

- Digital taxes are intended to address a potential mismatch between where profits are taxed under traditional tax principles and how and where digital activities create value
- The value creation is related to certain elements unique to digital business models
  - Highly digitalized businesses can be heavily involved in the economic life of a jurisdiction without any, or any significant, physical presence ("cross-jurisdictional scale without mass")
  - Such businesses are also highly reliant on intellectual property, which is mobile
  - A high level of value comes from data, user participation, network effects, and the provision of user-generated content
    - For example, online social networks would not exist without data, network effects and user-generated content
- In the absence of a global consensus, many countries have unilaterally implemented taxes that target the digital economy

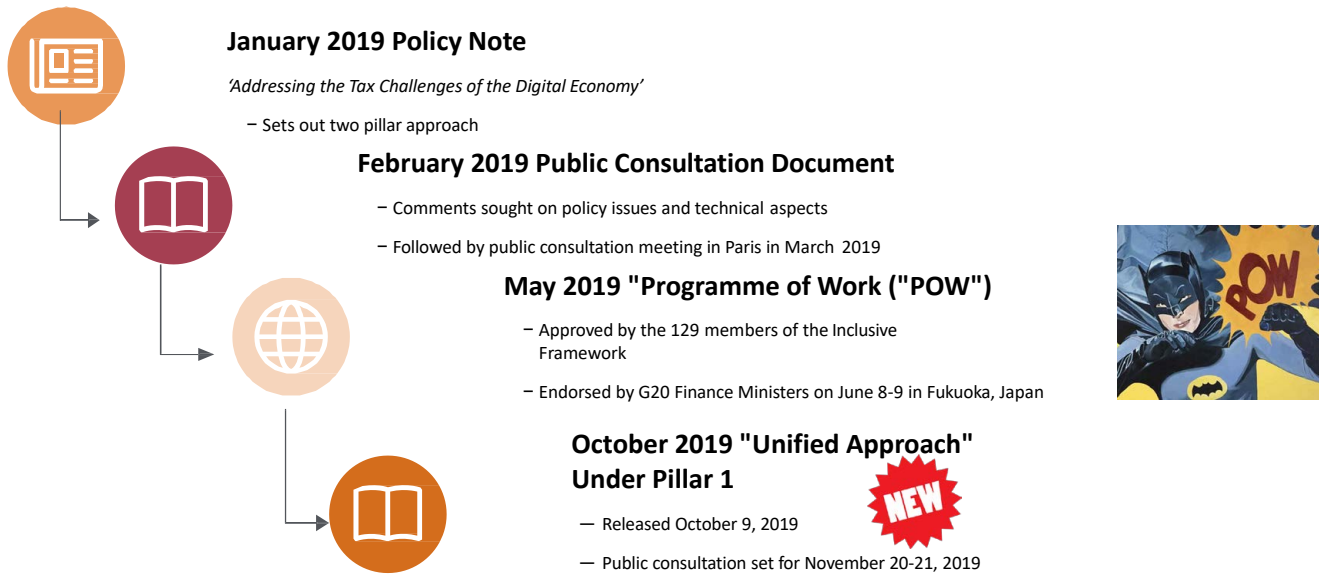
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## EXAMPLE: FRENCH DIGITAL SERVICES TAX



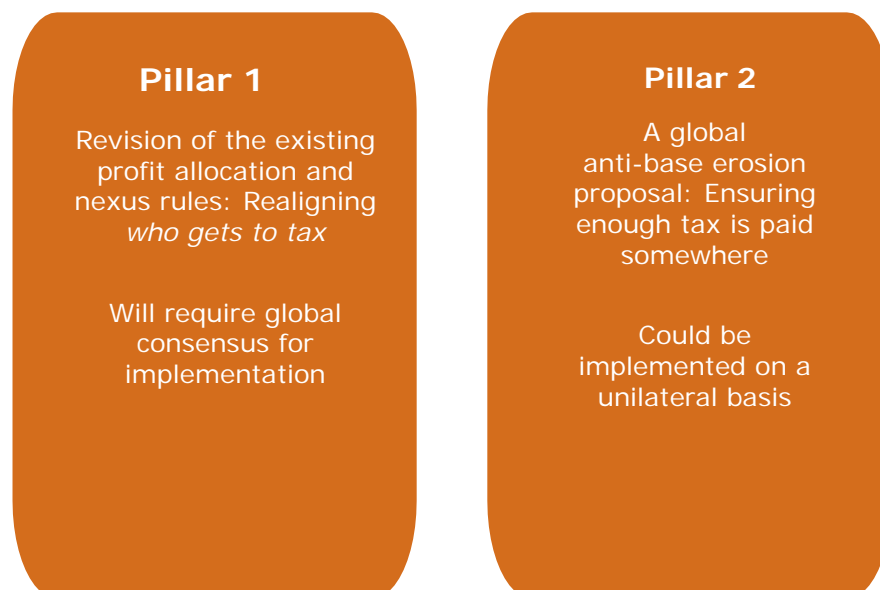
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# OECD – PROGRESS TO DATE IN DEVELOPING CONSENSUS



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## PROGRAM OF WORK – TWO "PILLARS"



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## WHY ARE THESE PROPOSALS IMPORTANT TO YOU?

- They will not impact the documentation reports you are working on today
- They may depart from the arm's length standard, which could significantly impact the practice of transfer pricing
- They could impact your company
  - The digitalization of the economy can not be “ring fenced”
  - New rules may significantly impact where tax will be paid
  - There are likely to be winners and losers at the enterprise and country level

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## OCTOBER 9, 2019 "UNIFIED APPROACH" FOR PILLAR ONE – KEY FEATURES

### 1. Scope



- a. Large “consumer-facing” businesses (*not* the same as B2C)
- b. Size threshold to be determined; €750M revenue suggested as an option
- c. Extractives assumed out of scope; other sector carveouts?

### 2. New nexus



- a. Sustained and significant involvement in the economy of a market jurisdiction regardless of physical presence
- b. Revenue could be the primary indicator of sustained and significant involvement
- c. Potential thresholds, e.g., country-specific sales thresholds

- d. New self-standing treaty provision

### 3. New profit allocation rule



- a. Goes beyond arm's length principle
- b. Calculated using a three-tier mechanism

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## PROPOSED THREE-TIER PROFIT ALLOCATION MECHANISM

**Amount A:** a share of an MNE's non-routine return attributable to market intangibles allocated to market jurisdictions using a formulaic approach

1. Identify the group's profits, potentially from consolidated financial statements
2. Identify "routine" profits to be excluded from allocation, using a "simplified" approach based on a fixed percentage
3. Determine the split of remaining non-routine profits between the portion attributable to market intangibles vs. to other factors (trade intangibles, capital and risk), using a simplified convention such as a fixed percentage
4. Allocate the relevant amount, based on an allocation key such as sales

**Amount B:** a fixed return for baseline marketing and distribution functions that take place in a market jurisdiction

**Amount C:** an additional return in accordance with existing transfer pricing rules when a market jurisdiction can successfully establish – subject to robust and binding dispute resolution mechanisms – that there are more functions in the market jurisdiction than have been included in Amount B

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## EXAMPLE OF PROFIT ALLOCATION UNDER UNIFIED APPROACH

- Group X: highly profitable streaming services
- P Co, located in Country 1, is the parent and owns all Group X IP
- Q Co, located in Country 2, is a subsidiary responsible for marketing and distributing Group X's streaming services
  - Q Co sells them directly to Country 2 customers
  - Q Co sells them remotely to Country 3 customers, where it does not have any form of taxable presence under current rules
- Amount A: Does Group X have a new non-physical nexus in Country 2?
  - If so and if Q Co meets revenue threshold, Country 2 can tax a portion of Group X's non-routine profits
  - Country 2 may tax that income directly from P Co; Q Co jointly liable for the tax
  - Relief from double taxation available once P Co claims FTC or exemption in Country 1
- Amount B: Q Co subject to fixed return for baseline marketing and distribution activities in Country 2
  - Transfer pricing adjustments can be made between P Co and Q Co to eliminate double taxation
- Amount C: Does Q Co perform functions and bear risks beyond the baseline activity in Country 2?
  - If so, Country 2 may be able to tax an additional return for Q Co, subject to robust and binding measures to resolve disputes

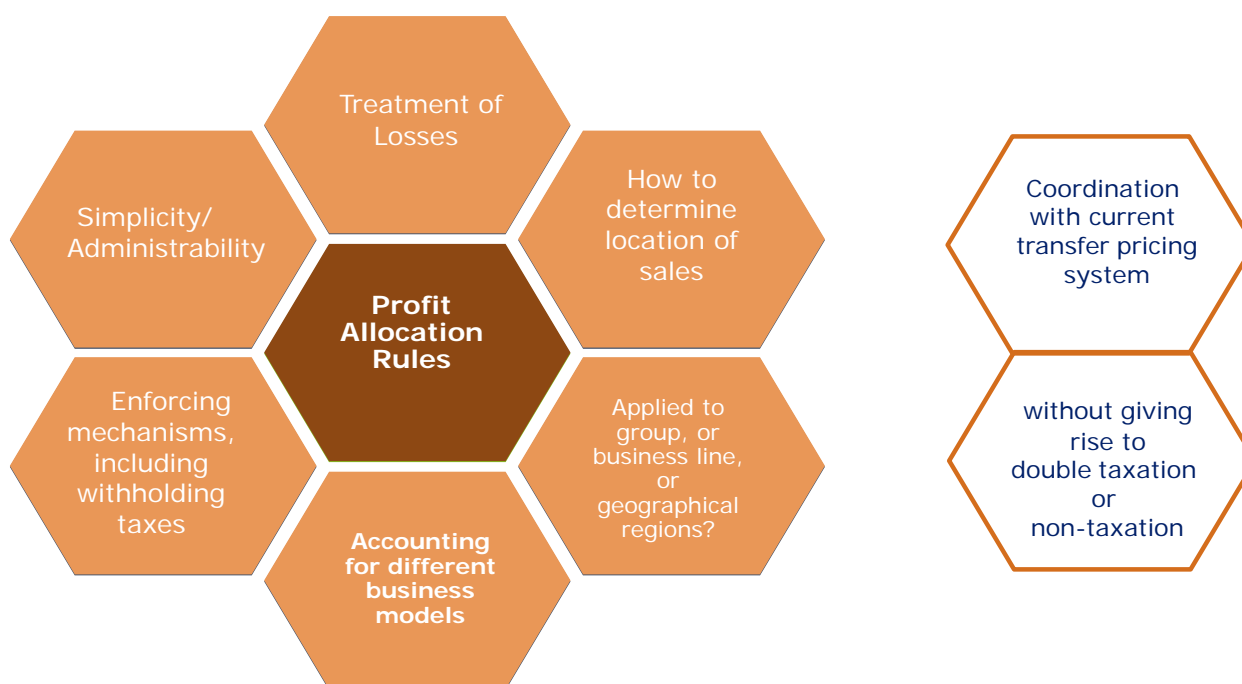
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## EXAMPLE OF PROFIT ALLOCATION UNDER UNIFIED APPROACH (CONT'D)

- In Country 3, Group X does not have a taxable presence under existing rules, but is making sales there
- Amount A: Does Group X have a non-physical nexus in Country 3 and does it meet the revenue threshold?
  - If yes, Country 3 has the right to tax a portion of the deemed non-routine profits of Group X
  - Country 3 may tax that income directly from P Co because P Co is held to have a taxable presence in Country 3 under the new nexus rules
- Amount B: would not apply here because Group X does not have an in-country presence in Country 3

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## PRACTICALITIES – OTHER PROFIT ALLOCATION DESIGN CONSIDERATIONS



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## IMPACT ON ARM'S LENGTH STANDARD

- OECD concedes that the allocation rules “go beyond” the arm's length principle and depart from the separate entity approach
  - Arm's length principle is becoming an increasing source of complexity
  - Simplification is desirable to contain increasing administration and compliance costs of trying to apply it
- But unified approach needs to address several issues that deviating from the arm's length principle presents
  - Where will profits come from?
    - Example of Unified Approach posits that P Co's profits will be taxed
    - Consistency with DEMPE analysis and the potential of several IP owners within the group – how to allocate profits between them?
    - Relationship between Amount C (additional return above a baseline routine return for Country 2) and Amount A (allocation of residuals to Country 2) – how much residual profit should be allocated to Country 2 if Amount C applies?
  - Potential double taxation attributable to fixed returns
    - Application of a fixed routine return (step 2 of Amount A, Amount B) may over- or under-compensate actual functions performed
    - Deviation could create double taxation
    - Will the profit allocation rules override transfer pricing rules in case of conflict?

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## IMPACT ON ARM'S LENGTH STANDARD (CONT'D)

- Formulaic approach will require significant inter-governmental coordination to achieve global consensus and avoid double taxation
  - Existing treaty rules relieving double taxation apply to MNEs on an individual entity and individual-country basis
  - Differences in formulas between countries could create additional disputes involving multiple countries
  - New arbitration procedures could be necessary
- Potential that the approaches set out in Pillar 1 do not remain confined to digital services transactions
  - Which customer-facing businesses will be brought within its scope?

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## PILLAR 2 - GLOBE

- Rules to permit countries to tax profits where income is subject to **no or very low taxation**
- The proposal has **two inter-related elements**:



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## KEY TAKEAWAYS

- Process of reaching consensus remains in an early stage
  - Regarding nexus, the type of threshold (e.g., volume of sales) and the degree of local flexibility will need to be agreed in order to develop an appropriate new treaty article
  - How the proposals are going to be legally implemented still remains an open issue
- Increased compliance burden given the additional complexity of the new formulaic Amount A and its interaction with Amounts B and C
- If not uniformly applied, could lead to additional dispute and double taxation risks
- Reallocation percentages are not based on ALP, therefore could be subject to constant pressure for change
- Unified Approach is far from simple, therefore, companies will want to analyze the potential impact on their business models and engage with the OECD and policymakers at both national and multilateral levels on the business implications of these proposals
- Public comments on the Unified Approach are due November 12, with a public consultation to follow on November 21-22

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# LITIGATION UPDATE

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## LITIGATION UPDATE

- *Altera v. Commissioner* (stock-based compensation)
- *Amazon.com v. Commissioner* (cost sharing buy-in)
- *Facebook v. Commissioner* (platform contribution transaction)
- *Medtronic v. Commissioner* (comparable uncontrolled transaction ("CUT") / comparable profits Method ("CPM"))
- *Coca-Cola v. Commissioner* (CUT / CPM)

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## ALTERA V. COMMISSIONER

- Did Treasury comply with the Administrative Procedure Act ("APA") in amending regulations to require inclusion of SBC in CSA cost pools?
- *Tax Court (2015)*: reasoned decision-making standard required for APA not met
  - No evidence that uncontrolled parties share SBC
  - Treasury did not adequately consider empirical evidence or respond to comments
- *Ninth Circuit (2019)*: 2-1 decision: appropriate standard is not comparability but commensurate with income ("CWI")
  - Internal standard: allocation of costs and income must reflect actual economic activity
  - Treasury's response to comments regarding regulation based on CWI
  - Treasury thus complied with reasoned decision-making requirements of APA
- Altera petitioned the Ninth Circuit for a rehearing *en banc*; decision pending
- July 2019, IRS withdrew directive preventing IRS examiners from auditing issue
- Taxpayers are currently taking different approaches to SBC inclusion in CSAs

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## AMAZON.COM V. COMMISSIONER

- What is the appropriate scope of IP to be included in a buy-in under 1995 cost sharing regulations, and what is the appropriate method to value the IP?
  - *Amazon*: unspecified method with limited useful life and limited IP scope
  - *IRS*: DCF with full value of IP captured by terminal value into perpetuity and IP valued in aggregate (technology and trade intangibles with residual business intangibles)
- *Tax Court (2017)*: 1995 regulations do not support DCF or aggregate approach
  - Places artificial cap on returns a cost sharing participant may earn
  - Residual business IP not compensable under those regulations
  - Buy-in payment is required only for preexisting IP, not IP developed under CSA
- *Ninth Circuit (2019)*: IP definition under 1995 regulations does not include residual business assets
  - Rejected use of DCF because it includes such assets.
  - If case were governed by 2009 regulations or 2017 statutory amendment (requiring aggregated approach to IP transfers), "there is no doubt the Commissioner's position would be correct"

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## FACEBOOK V. COMMISSIONER

- Issue is valuation of platform contribution intangibles transferred under 2009 regulations
- *Facebook*: Value is approximately \$6.7 billion
  - Intangibles were transferred in separate agreements and include
    - Facebook's platform
    - Facebook non-U.S. user base
    - Non-exclusive right to use Facebook marketing intangibles (trademarks, service marks, trade names, domain names)
- *IRS*: Value is approximately \$13.9 billion
- Trial scheduled for early 2020

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## MEDTRONIC, INC. V. COMMISSIONER

- What is the best method for pricing manufacturing functions performed by Puerto Rican subsidiary ("MPROC") related to pacemaker devices and leads?
- *Medtronic*: comparable uncontrolled transaction ("CUT") method
  - Royalty based on MOU with IRS from 2002 audit, applied to 2003-2006
  - MPROC performs value-added functions
- *IRS*: comparable profits method ("CPM") – 2005/2006 audit
  - MPROC benchmarkable tested party
- *Tax Court (2016)*: CUT is best method
  - MPROC's functions, market risks, and responsibilities (especially for quality) could not be benchmarked with routine manufacturing comparables
  - Prior Medtronic litigation settlement agreement ("Pacemaker," involving 7% royalty) is best CUT; adjustments yield royalty rates as in IRS MOU
- *Eighth Circuit (2018)*: Remanded case for further analysis of best method, circumstances and comparability of Pacemaker agreement, adjustments made, and risk allocation

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## COCA-COLA VERSUS COMMISSIONER

- Best method for determining trademark and formula royalty paid by foreign “supply points,” which manufacture concentrate for sale to non-U.S. bottlers
- *Coca-Cola*: company had used “10-50-50” method for over 20 years
  - Supply point retained 10% of gross revenues as routine return; residual operating income (after adjustments) split 50%-50% between the supply point and Coke
  - IRS accepted method in closing agreement covering 1987-1995
  - IRS did not challenge method in audits from 1996-2006
- *IRS*: CPM is best method
  - Applied CPM in 2007-2009 audit
  - Compared supply points to uncontrolled beverage bottlers
  - Transfer pricing adjustment is approximately \$9 billion
- *Tax Court*: Trial and post-trial briefing complete. Awaiting opinion

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## TRANSFER PRICING PRACTICE – HOT TOPICS

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## TRANSFER PRICING PRACTICE – HOT TOPICS

### **Withdrawal of Stock Based Compensation Directive**

- ❖ On June 7, 2019, the United States Court of Appeals for the Ninth Circuit reversed the U.S. Tax Court's opinion in *Altera*.
- ❖ The Stock Based Compensation Directive was withdrawn in July, 2019.
- ❖ Examiners will apply Treas. Reg. Sections 1.482-7A(d)(2) and 1.482-7(d)(3).

### **CAP Recalibration – Transfer Pricing**

- ❖ CAP taxpayers must now complete a Material Intercompany Transaction Template (MITT) form which is used as part of the risk assessment process.
- ❖ Goal is for the risk assessment to be effectively utilized to either de-select issues that do not warrant scrutiny, or to ensure the appropriate treatment stream is used:
  - Issue resolved within CAP process timeline,
  - Advance Pricing Agreement (APA), or
  - Examination.

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## TRANSFER PRICING PRACTICE – HOT TOPICS

### **Field Collaboration With Advance Pricing and Mutual Agreement**

- LB&I issued new guidance to examiners on February 19, 2019 requiring collaboration between transfer pricing issue teams and APMA on examinations with the potential to generate a transfer pricing adjustment involve a country with a tax treaty with the U.S.
- Our goal here is to ensure that teams understand and consider the treaty background and competent authority experience with the treaty partner and/or transfer pricing issues.

### **Transfer Pricing Examination Process**

- The Transfer Pricing Examination Process (Publication 5300) was issued in August 2018 and replaced the former Transfer Pricing Roadmap.
- Updated May 29, 2019.
- Incorporates process changes, new directives, IRM updates, etc.

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# TRANSFER PRICING PRACTICE – HOT TOPICS

## **Transfer Pricing Centralized Risk Assessment**

- International Compliance Assurance Program (ICAP) Pilot cases.
- Compliance Assurance Process (CAP) cases.
- Large Corporate Compliance (LCC) Cases.



THANK YOU