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OECD's Inclusive Framework renews commitment to efforts to address tax challenges from digitalization of economy

The OECD on January 31 released a "Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalization of the Economy."
URL: http://www.oecd.org/tax/beps/statement-by-the-oecd-g20-inclusive-framework-on-beps-january-2020.pdf

The statement affirmed the commitment of the 138-member Inclusive Framework to reach an agreement on a consensus-based solution by the end of 2020, while deferring a decision on US Treasury Secretary Mnuchin's

December 2019 proposal for a "safe harbor" approach to Pillar One until other elements of the solution have been agreed.[1]

The statement is accompanied by two annexes. The first annex, an "Outline of the Architecture of a Unified Approach on Pillar One," has been agreed as the basis for negotiations and the second is a progress note on Pillar Two. The statement explains that any agreement on a reallocation of taxing rights under Pillar One would require improved tax certainty, including effective and binding dispute prevention and resolution mechanisms.

The statement highlights a number of other issues where significant divergences will have to be resolved. These include (i) the binding nature of dispute prevention and resolution mechanisms as well as the scope of the dispute resolution mechanisms; (ii) the suggestion by some members to weight the quantum of Amount A to account for different degrees of digitalization between in- scope business activities (so-called "digital differentiation"); and (iii) the suggestion by some countries to account for regional factors in computing and allocating Amount A (through regional segmentation). The statement further notes that some jurisdictions and businesses had expressed concerns about the continued application of digital service taxes (DSTs).

Pillar One – Nexus and Profit Allocation

The OECD Inclusive Framework has endorsed in Annex 1 an outline of the architecture of a unified approach as the basis for negotiations of a consensus-based solution under Pillar One. The unified approach is designed to adapt countries' taxing rights to take into account new business models and reallocate taxing rights in favor of the user/market country. Three possible types of taxable profit may be allocated to a market country:

- A share of a multinational business' non-routine return attributable to market intangibles (vs. that attributable to other factors, such as trade intangibles), determined using a formulaic approach, irrespective of the business' residence or locations (Amount A).
- A fixed return based on the arm's length principle for baseline marketing and distribution functions taking place in a market jurisdiction (Amount B).
- An additional return (Amount C) determined 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 jurisdictions than have been accounted for and included in Amount B.

Amount A – new taxing right

Scope

Two broad types of business have been identified as within the scope of the new taxing right:

- **Automated digital services** provided on a standardized basis to a large user base across multiple jurisdictions (without regard to whether they are consumer-facing).
    - These include online search engines, social media platforms, online intermediation platforms (including online marketplaces used by businesses or consumers), digital content streaming, online gaming, cloud computing services, and online advertising services.
    - Professional services requiring significant human input despite digital delivery, such as legal, accounting, architectural, engineering, and consulting services, are not in scope.
- **Consumer-facing businesses** that generate revenue from the sale of goods and services of a type commonly sold to consumers.
    - Consumer products sold indirectly through third-party resellers and by intermediaries that perform routine tasks (such as minor assembly or packaging) are in scope (but only if the special nexus requirements described below are met).
    - Businesses that generate revenue from licensing rights over trademarked consumer products and those that generate revenue through licensing a consumer brand (and commercial know-how) such as under a franchise model are also in scope.

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[1] Pillar One focuses on revising the allocation of taxing rights among countries, potentially including new approaches to nexus (permanent establishment) issues and the arm's length principle, and Pillar Two seeks to ensure that companies are subject to a minimum level of taxation globally.

- The sale of intermediate products/components that are incorporated into a finished consumer product sold to consumers will be out of scope, with a possible exception if the item is branded and commonly acquired by consumers for personal use.
- Examples of in-scope consumer-facing businesses include: personal computing products (such as software, home appliances, mobile phones); clothes, toiletries, cosmetics, luxury goods; branded foods and refreshments; franchise models, such as licensing arrangements involving the restaurant and hotel sector; and automobiles.
- Extractive industries and other producers/sellers of raw materials and commodities are excluded, even if those materials/commodities are incorporated into consumer products further down the supply chain.
- Regulated consumer-facing business lines in the financial services sector, such as retail banks and insurance, are broadly excluded from scope. However, consideration might be given to whether there are any unregulated elements of the financial services sector or related to the sector that require special consideration, such as digital peer-to-peer lending platforms.
- Airline and shipping businesses will not be in scope.

Activities may need to be segmented to separate in-scope from out-of-scope segments. When a business sells to both businesses and consumers, the revenues would be in scope if the product is of a type commonly sold to consumers.

Thresholds

Several thresholds are being considered, but none have been agreed to yet:

- Group gross revenue threshold – possibly in line with the EUR 750 million revenue threshold used for country-by-country reporting;
- *De minimis* test on the total aggregated group in-scope revenue from consumer-facing activities and/or automated digital services; and
- A carve-out where the total profit to be allocated under Amount A (the aggregate deemed residual profit) does not meet a *de minimis* amount.

New nexus (taxable presence) rules

The new rules would create a nexus for in-scope businesses with a significant and sustained engagement with a market country, based on the generation of in-scope revenue in a market country over a period of years. For consumer goods businesses, a new nexus will not arise if the group is selling consumer goods into a market jurisdiction without a sustained interaction with the market – e.g., the existence of a physical presence in, or targeted advertising directed at, the market country.

A liability would arise in the market country if a country-specific sales threshold is exceeded. The threshold would be commensurate with the size of the market to ensure countries with smaller economies are included, but with an absolute minimum amount. Further work will be undertaken to design rules that source revenues to markets, for example, to allocate revenue from online advertising services to the user's location and to determine how revenues are sourced when goods are sold via intermediaries.

This measure will require a new stand-alone tax treaty provision (in addition to the existing permanent establishment and business profits articles). Filing and other tax related obligations will be minimized when possible. Simplified reporting and registration-based mechanisms (e.g., a 'one-stop shop') and exclusive filing in the ultimate parent country (in line with the approach for country-by-country reporting) will be explored. The new nexus is exclusively applicable to the new taxing right under Amount A and cannot be used as a basis for creating a nexus for any other purpose, including the imposition of VAT and customs duties.

Quantum of Amount A – formulaic approach

Step 1: Determine total profit of the group

The calculation of Amount A will be based on a measure of profit derived from the consolidated group financial accounts, with profit before tax as the preferred profit measure. It is anticipated that this will be broadly consistent across countries and that only minimum material adjustments are likely to be needed. The rules will apply to both profits and losses and will include loss carry-forward rules.

Segmented accounts may be required to identify in-scope business segments. Further segmentation by in-scope business lines (when profitability varies) and/or region will be explored in the context of balancing the need for simplicity and accuracy, and to take compliance burdens into account.

Step 2: Determine the group's residual profit by excluding deemed routine profit

A simplified approach based on agreed fixed percentage(s), with possible variances by industry, is being considered, to approximate the profit from routine activities.

Step 3: Allocate a portion of deemed residual profit

Non-routine profits may be attributable to many activities, including those not identified by the new taxing right, such as intangibles, capital, and risk.

For simplicity, an agreed fixed percentage could be used to identify the amount of routine profits to be attributed to the market country under the new taxing right.

The portion of deemed residual profit could be weighted to account for different degrees of digitalization between in-scope business activities ('digital differentiation').

Step 4: Allocate the relevant portion of deemed residual profit to market countries

The allocation will be based on in-scope sales.

Elimination of double taxation

Amount A is an overlay to the system of allocating profits on the basis of the arm's length principle. As the arm's length principle already allocates all the group profit, it is recognized that it is essential that there be appropriate mechanisms to eliminate double taxation and further work will be undertaken in this area.

Interactions and potential for double counting

A business would first apply arm's length principle-based profit allocation rules, including Amounts B and C, followed by the application of Amount A rules.

Further consideration will be given to possible instances of double counting under Amounts A and C, including in respect of: marketing intangibles in the local country, comparability adjustments under the arm's length principle, and uncommon interpretations of the arm's length principle. No significant interaction is expected between Amounts A and B.

Amount B – Fixed return for defined baseline and marketing activities

Amount B aims to standardize the remuneration of "baseline marketing and distribution activities" to increase simplification in the administration of transfer pricing and to enhance certainty. A fixed return for in-scope activities based on the arm's length principle is proposed, and Amount B rules would not be optional nor a safe harbor.

Future work will explore how to take account of different functionality levels, and differentiation in treatment between industries and regions, in determining the fixed return. A key consideration will be the determination of an appropriate profit level indicator. The definitions of baseline activities are to be examined further but will likely include distribution arrangements with routine levels of functionality, no ownership of intangibles, and no or limited risks.

Increased tax certainty, dispute prevention and resolution

The unified approach seeks to increase tax certainty for businesses and tax authorities, with enhanced dispute resolution considered a key component of Pillar One.

For Amount A, work will be undertaken to develop an innovative approach, supported by a clear, administrable, and binding process, to provide early dispute prevention. This could include reviews by representative panels made up of members of tax authorities. Options will be developed for appropriate mandatory binding dispute resolution for Amount A when a business has not opted in to the early certainty process.

Amount B rules will be designed to limit the potential for disputes and will be further limited by the provision of clear and detailed guidance on its scope. For Amounts B and C, there are currently differing positions within the Inclusive Framework on the breadth of application of enhanced dispute resolution mechanisms, and the adoption of mandatory binding arbitration may not be possible in all countries. It may therefore be necessary to consider other mechanisms. The importance of enhancing mutual agreement procedures (MAP) and ongoing work to improve the effectiveness of multilateral MAP is recognized.

Implementation and administration

A new multilateral convention will implement changes to tax treaties consistently and substantially at the same time. This would supersede the relevant provisions of existing treaties or create a framework between countries without a current treaty.

Appropriate infrastructure will be put in place to support consistent administration of the new taxing right, while keeping compliance and administrative costs at a minimum. Due to the number of new requirements associated with the new taxing right, certain elements may be introduced on a phased basis and/or initially on a simplified transitional basis.

The proposal for an alternative safe harbor basis, whereby an electing group would agree, on a global basis, to be subject to Pillar One, is to be considered in further detail. A final decision will be made after the other elements of the consensus-based solution have been agreed upon.

Commitment to withdraw relevant unilateral actions

It is expected that any consensus-based agreement must include a commitment by Inclusive Framework members to withdraw relevant unilateral actions, such as digital services taxes.

Pillar Two – Global anti-base erosion proposal

The document includes a progress note on Pillar Two, the global anti-base erosion proposal. This will enable countries to tax profits that would otherwise be taxed at an effective rate below a 'minimum rate.' The progress note states that significant work on key issues is advancing at a fast pace, with technical progress on many aspects of the proposal, but that significant work remains.

Next steps

The statement includes a revised Program of Work for Pillar One, published as Annex A, with remaining issues divided into 11 separate work streams. An OECD webcast on the economic analysis and impact assessment of the proposals is scheduled for 13 February 2020.

The Inclusive Framework intends to reach agreement on the key policy features of Pillar One by early July 2020, including the definition of the categories of business activities that fall within the scope of the new taxing right, and the determination of the appropriate thresholds for the percentage(s) of profits that will be reallocated under the new taxing right. Remaining work is to be completed by November 2020 with a view to agreeing and publishing a final report by the end of 2020.

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Germany introduces legislation to enact significant changes to transfer pricing rules

The German Federal Ministry of Finance (MoF) published a draft law on 10 December 2019 that would implement the EU anti-tax avoidance directive. The draft includes a far-reaching revision of sec. 1 Foreign Tax Code (FTC) and certain amendments to the General Tax Code (GTC) pertaining to the German taxation of cross-border transactions. Sec. 1 FTC serves as the core legal basis for transfer pricing adjustments in German tax law and defines the main aspects of the German interpretation of the arm's length principle.

The draft law is intended to represent a profound revision reflecting recent developments based on the OECD's base erosion and profit shifting (BEPS) project.

An overview of the most important aspects of the draft law from a German transfer pricing perspective follows.

Function and risk analysis and transfer pricing method

According to the MoF's explanatory memorandum accompanying the draft legislation, the goal of the sec. 1 FTC revision is to introduce a more precise version of the German interpretation of the arm's length principle by comprehensively implementing the principles laid out in the OECD's 2017 transfer pricing guidelines into German law. The MoF proposes the following changes to the existing law:

- Eliminating the current hierarchy of transfer pricing methods;
- Prioritizing the taxpayer's actual conduct, and the facts and circumstances of the business transactions (instead of the contractually agreed conditions); and
- Codifying the functional and risk analysis as the basis to determine if the business transactions are deemed comparable.

The MoF also proposes implementing the internationally adopted "best method rule" as per the draft provisions in sec. 1 para. 3 sentence 5 of the FTC. The draft law requires that the taxpayer select the most appropriate transfer pricing method, considering the advantages and disadvantages of each method. Moreover, the draft states that only information objectively available at the time the agreement regarding the business transaction was concluded may be used to determine the arm's length price; however, the practical consequences of this proposed provision are not further clarified. Finally, in the draft sec. 1 para. 3a FTC, the MoF proposes the adoption of the interquartile range as the general approach for narrowing the range resulting from benchmarking analyses.

Intangibles

For the first time, the MoF has introduced a legal definition of the term "intangibles" in the newly proposed sec. 1 para. 3c FTC, based on the OECD transfer pricing guidelines. However, the proposed definition is vague, and it is unclear whether it will achieve the desired outcome.

The draft law proposes the implementation of the "DEMPE" (development, enhancement, maintenance, protection and exploitation of intangibles) concept – originally developed by the OECD – in German tax law. The DEMPE concept provides for entitlement to returns derived from intangibles based on the performance of essential functions and the bearing of risks, as well as the use of assets in connection with intangibles. However, the draft does not provide clear guidance on the extent of the income allocation associated with the performance of these functions in specific cases. Nevertheless, a mere financing of these functions should not entitle the financer to a return from the financed intangibles but should be remunerated as a mere financing function.

In this context, some relevant questions remain unanswered, such as:

- Which DEMPE functions, and under which circumstances, would entitle an entity to the returns derived from the exploitation of intangibles, and what is the extent of the entitlement?
- Under what circumstances is the profit split method applicable, and what criteria should be applied for an appropriate profit allocation?
- How should losses be treated and what are the consequences of the sale of an intangible for the parties involved?

Finally, the draft does not include legally binding clarifications, which would be indispensable for the application of the DEMPE concept in practice.

Price adjustment clause

The new price adjustment clause, outlined in a newly proposed sec. 1 b FTC, would be applicable to all business transactions that involve valuable intangibles. The clause therefore would no longer be applicable only to business transactions with intangibles to which the so-called hypothetical arm's length comparison is to be applied. A significant deviation during the first seven years (more than 20 percent in relation to the original arm's length price based on actual profit development) would trigger the application of the envisaged price adjustment clause. An income adjustment equal to the amount of the deviation would be made in the eighth year after the conclusion of the transaction.

There draft law includes three defined exceptions to this rule:

1. The provision of prima facie evidence of the unpredictability of the circumstances triggering the actual developments;
2. Proof of appropriate consideration of the uncertainty resulting from future developments within the transfer pricing agreement; and
3. A license/IP transfer agreement with revenue-based or profit-based compensation.

The draft does not specify how "proof" under the second exception may be provided. In this respect, prima facie evidence seems possible at best.

The extension of the scope for the application of the price adjustment clause – based on the current wording of the draft – contradicts the explanatory memorandum, which appears to assume that the content of the draft corresponds to the provision currently in place. This would have a significant impact, in particular because in practice the arm's length pricing for intangibles transactions is usually demonstrated via databases.

The reduction of the relevant period from 10 to seven years is generally favorable. However, the arm's length nature of this regulation remains questionable, as unrelated parties most likely will not agree on price adjustment clauses covering a seven-year period into the future.

Transfer of functions

The so-called "escape clauses" – currently in force in sec. 1 para. 3 sentence 10 FTC – that allow an individual valuation of the transferred assets instead of a transfer package valuation under certain conditions have been removed in the proposed draft. This would result in a stricter application of transfer of function taxation rules compared to current law. As a result, in the future, cases that involve neither a transfer nor a license of essential intangibles would become subject to the transfer of functions rules.

The draft emphasizes that transfer packages should be valued using economically accepted valuation methods. To this end, the relevant valuation and presumption rules of the current legislative decree (e.g., unlimited capitalization period and tax gross-up), which deviate from the international standard, will no longer apply. Consequently, the currently valid relocation of functions decree would lose its legal basis in this respect.

Financial transactions

The newly proposed sec. 1a of FTC begins with a so-called treaty override provision, which stipulates that the positions set out in the section apply irrespective of existing double tax treaties.

In our view, the new section would apply only to the interest expenses of German taxpayers (that is, only for inbound transactions). The deductibility of any interest expense incurred would be denied for tax purposes unless prima facie evidence can be presented that:

- The debtor will be able to serve the debt (including both interest payments and principal repayment, according to the explanation to the draft law) over the term of the debt, and was able to do so at the time the loan was granted; and

- The loan is required from a business perspective and the funds are used for the company's business purpose (based on explanations to the draft law, the primary purpose of this provision seems to be the desire to keep the borrowing company from depositing the proceeds from that loan in the group's cash pool).

The arm's length interest rate would resemble the interest rate at which the group could finance itself on the capital market. The guidance on creditworthiness in the draft law suggests that the group rating would apply, unless the borrower's creditworthiness is better than the group's creditworthiness (that is, if the borrower is rated higher than the group); in that case, the borrower's stand-alone rating would apply.

Taxpayers would be free to demonstrate that a different interest rate (a higher interest rate than the interest rate determined with the group rating) is at arm's length. While it would be expected that the tools to demonstrate this would include state-of-the art transfer pricing loan benchmark analyses, the explanation of the draft law does not elaborate on this issue.

In practice, this may effectively lead to a shift of the burden of proof to the taxpayer if the taxpayer deems another approach/interest rate more appropriate than the one determined based on the group rating or based on the interest rate at which the group could refinance itself.

Intragroup financing activities (including the arrangement of loans, back-to-back lending and forwarding, and typical functions of financing companies such as liquidity management, financial risk management, and foreign exchange risk management, which are explicitly mentioned) are generally regarded as routine services. According to the explanations to the draft law, such services would be remunerated on a cost-plus basis (explicitly referring to the cash pool leader). However, the draft law continues to stipulate that such activities should be remunerated based on a "risk-free interest rate," based on "term-equivalent governments bonds of the highest creditworthiness," which we believe to be an obvious contradiction.

Related parties

The draft expands the definition of related parties in sec. 1 para. 2 FTC, partly to avoid the tax evasion that would occur in cases in which related entities issue non-voting shares or enter into voting agreements. Furthermore, a close relationship between entities can now be established through close strategic and professional coordination within a network; however, this is based only on the draft's explanatory memorandum, and no specific basis for this conclusion can be found in the draft law itself.

Master file

The draft law reduces the turnover threshold for the obligation to prepare a master file from EUR 100 million to EUR 50 million, which is likely to result in a considerable increase in the number of taxpayers subject to the master file filing requirement in Germany.

The master file must be filed electronically with the competent tax office "at the latest after the end of a fiscal year." The draft law does not provide a specific due date for filing the master file, nor a reference to a specific event, such as the date of submission of the annual tax return for the respective fiscal year. It would be virtually impossible to fulfil this obligation if the taxpayer is required to file the documentation at the latest by the beginning of the next fiscal year.

Advance pricing agreements (APAs)

The draft law codifies the requirements and procedure to obtain an APA and creates a legal basis for the APA program in sec. 89a GTC. The legislature intends to increase legal certainty in cross-border contexts to avoid international disputes.

The newly introduced draft defines a number of prerequisites that must be met before an APA request can be initiated. From a practical point of view, the draft law appears to be too restrictive in this regard. For example, it is unlikely that taxpayers would apply for an APA without the impending risk of double taxation. Unnecessary applications would also be kept in check given the increased obligations for cooperation in an APA procedure and the resulting transparency, as well as the application fees, which must be paid in advance.

The draft increases the basic fee for an APA application from EUR 20,000 to EUR 30,000. The fee may be reduced if the APA follows a coordinated bilateral or multilateral tax audit ("joint audit"). This would create an additional incentive to secure the outcome of a joint audit for the future. In our opinion, joint audits now offer a good opportunity for efficiently avoiding tax conflicts and double taxation in advance. A sort of "fast track" APA procedure would be possible, as a comprehensive fact-finding process would already be performed – to a certain extent – in the course of the joint audit.

The newly introduced legislation largely follows the already published information regarding APAs, last updated by the tax authorities in 2018.

Application and legislative decree

The new legislation would enter into force on the day following its promulgation. The following is planned for the application of the new regulations in the transfer pricing area:

- The amended sec. 1 and sec. 1a and 1b FTC would apply from the 2020 assessment period onwards.
- The change in the threshold value for the master file documentation would apply for the first time to fiscal years beginning after 31 December 2020.
- The starting date for the obligation to submit the master file electronically will be determined in a separate legislative decree.
- The new sec. 89a GTC would apply for the first time to applications received by the competent authority after the provision's date of entry into force.

Despite the vast scope of the new rules, the legislature has not addressed some important issues in the draft law in a comprehensive way. To fill those gaps, the draft law provides a legal basis to regulate details of the arm's length principle within the meaning of sec. 1 paragraphs 1, 3, 3a, 3b, 3c, and sec. 5 FTC in a separate legislative decree. In addition, it would also make sense to adapt the existing legislative decrees and MoF circulars in light of the new rules.

Surprisingly, the draft law does not include a corresponding legal basis for the newly created sec. 1a and 1b FTC.

Further legal procedure

The next step in the legislative process is for the cabinet to discuss and vote on the draft law. However, the date of the vote has been postponed indefinitely (originally, the vote was expected to take place on 18 December 2019). After that, the law will go through further legislative steps and may also undergo revisions before enactment. Despite the tight deadline and given the significance of the planned changes, Deloitte Germany has submitted a preliminary statement to the MoF on the transfer pricing provisions in the draft law.

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Brazil considers convergence with OECD transfer pricing standards

The OECD on 18 December 2019 released the study "Transfer Pricing in Brazil: Towards Convergence with the OECD Standard," a detailed report that marks the conclusion of a joint project with the Brazilian Federal Revenue (RFB) launched in February 2018 to examine the similarities and divergences between the Brazilian and OECD transfer pricing approaches.
URL: http://www.oecd.org/tax/transfer-pricing/transfer-pricing-in-brazil-towards-convergence-with-the-oecd-standard.pdf

Background

In 2017, Brazil submitted a letter of intent to join the OECD, which triggered the initiation of several actions to assess the country's tax regime and propose amendments, including an in-depth analysis of the Brazilian transfer pricing legal and administrative framework.

The conclusions of this project, which assessed the Brazilian transfer pricing rules' strengths and weaknesses, as well as the limitations imposed on local taxpayers for access to value added functions, and the possibility of alignment with the OECD transfer pricing guidelines, were presented at a joint meeting of the OECD and RFB in July 2019. The report discloses in detail the methodology, analysis, and conclusions presented at the joint meeting.

Report's findings

The OECD segmented the project into three stages:

1. Preliminary analysis:
    a. Evaluation of Brazil's transfer pricing legal and administrative framework;
    b. Analysis of Brazil's and the OECD's transfer pricing backgrounds; and
    c. Definition of methodology, including the analysis parameters.
2. Assessment of strengths and weakness of Brazil's transfer pricing rules and administrative practices:
    a. Absence of the arm´s length principle from Brazilian transfer pricing rules;
    b. Applicability of local transfer pricing methods and documentation obligations;
    c. Positive and negative outcomes of Brazil's simplistic approach;
    d. Considerations on transactions not properly addressed by Brazilian rules; and
    e. Consequences for local taxpayers of not being fully integrated into multinational groups value chains.
3. Options for alignment:
    a. Possibilities to achieve full alignment with the OECD transfer pricing standard; and
    b. Explanation of the impracticality of a dual system in which both Brazil and OECD approaches would coexist.

The assessment of strengths and weakness comprised the core of the analysis. The concepts and objectives of the OECD guidance on transfer pricing were compared to the Brazilian transfer pricing framework. The gaps or issues identified were assessed according to the main policy objectives of transfer pricing legislation – securing the appropriate tax base in each jurisdiction and avoiding double taxation – and to the general tax policy objectives, compliance and tax certainty.

The assessment identified several issues resulting from gaps and divergences between the Brazilian and OECD transfer pricing frameworks, revealing weaknesses in the Brazilian rules that result in base erosion profit shifting (BEPS) and double taxation. The report acknowledges the strengths of the Brazilian transfer pricing system, especially in terms of ease of compliance and ease of administration by the tax authority, but concluded that the Brazilian rules do not secure the appropriate tax base in each jurisdiction.

The OECD's in-depth analysis addressed the simplicity of Brazil's transfer pricing rules and the concerns they give rise to. Even though the current system provides a practical and predictable approach, from fixed margins, the ability of taxpayers to choose the transfer pricing method, and the availability of safe harbors rules, it represents a trade-off between simplicity and accuracy that could create inappropriate outcomes, resulting in a loss of revenue for Brazil and double taxation and tax uncertainty for taxpayers in the cross-border context.

The report's principal findings, summarized in "Transfer Pricing in Brazil: Towards Convergence with the OECD Standard – Highlights," are as follows:
URL: http://www.oecd.org/tax/transfer-pricing/transfer-pricing-in-brazil-towards-convergence-with-oecd-standard-brochure.pdf

- Many of the gaps and divergences identified between the Brazilian transfer pricing regime and the OECD guidance increase the risk of double taxation;
- Many of those gaps create BEPS risks, leading to the loss of tax revenue;
- The existing system favors some categories of taxpayers to the detriment of others and provides tax planning opportunities;

- Tax administration and tax compliance aspects of the Brazilian system are generally conducive to ease of tax administration and tax compliance;
- Tax certainty is generally provided, but only from a domestic perspective; significant tax uncertainty is observed from an international perspective; and
- Further tax uncertainty, even domestically, results from the absence of special considerations or very limited guidance for issues related to specific types of transactions.

Given the project's conclusions and the Brazilian tax structure, any alignment with the OECD transfer pricing standard must consider a modern, simple, and efficient system. Nonetheless, the study group indicated that a complete alignment with the OECD transfer pricing guidelines must be achieved, and this conclusion was accepted by RFB.

Two alternatives for alignment were presented:

- Full and immediate alignment: All taxpayers would be simultaneously subjected to new Brazilian transfer pricing rules that reflect the OECD standard, including the arm's length principle and the guidance for its application contained in the OECD transfer pricing guidelines, on a specific date; or
- Full and gradual alignment: Same outcome as the immediate alignment option, but introduced in a structured and staged process, allowing a gradual implementation of the new provisions over a longer period of time.

A partial alignment, which would entail adoption of the OECD guidelines only in certain areas, or for specific transaction or taxpayers, was also evaluated during the project. However, partial alignment would mean that significant gaps would remain in the system, with negative effects on tax certainty, the compliance burden, and the risks of persisting double taxation and loss of tax revenue, and could have negative consequences for revenue collection, allowing tax planning based on the regime that is most favorable from a tax perspective.

Even though a dual system (as other countries have enacted) is not under discussion, some nationalization of the OECD guidelines is expected. In Brazil, considering the history of simplistic, straightforward approaches, this process should take the form of safe harbor regimes. Such nationalization will be part of a draft legislation discussion, for which no agenda or schedule has been set.

Given that convergence has been agreed to by the OECD and RFB, and the Brazilian government has reaffirmed its intention to become an OECD member, a full alignment of the transfer pricing rules is just a matter of time. The next steps were set at the report presentation and involve:

1. The release of a blueprint and roadmap for convergence, to be developed in 2020;
2. Conclusion of the policy design of the system, including an impact assessment from the RFB on local tax collection;
3. Developing draft legislation;
4. Establishing a plan for capacity building for the tax administration; and
5. Development of safe harbor regimes.

These next steps will involve a dialogue with taxpayers, including the engagement of associations and technical working groups focusing on specific areas, and will include a public consultation regarding the proposal.

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Australian tax authorities focus on cross-border intangible transactions

The Australian Taxation Office (ATO) has identified transfer pricing and anti-avoidance concerns associated with various international related-party intangible arrangements.

The ATO on 22 January released Taxpayer Alert (TA 2020/1), outlining concerns regarding the "mischaracterisation" of activities/payments in connection with intangible assets, and the migration of intangible assets. Taxpayer Alerts are

issued by the ATO to highlight its concerns about certain arrangements it considers to be higher risk, and to outline the ATO's approach to such arrangements. The release of TA 2020/1 highlights the ATO's increased focus on intangibles-related issues that may lead to inappropriate outcomes for Australian tax purposes.
URL: https://www.ato.gov.au/law/view/document?DocID=TPA/TA20201/NAT/ATO/00001&PiT=99991231235958

Broadly, TA 2020/1 describes arrangements whereby Australian entities are not appropriately remunerated for functions performed, assets used, and risks assumed in connection with intangible assets. Of particular concern are issues relating to the migration of Australian intangible assets to international related parties on non-arm's length terms or in a manner intended to avoid tax in Australia. The ATO has provided examples of arrangements of concern, though the ATO also indicates that its concerns extend beyond the specific arrangements outlined.

In broad terms, the ATO identifies two arrangements:

1. Arrangements involving the bifurcation of intangible assets and mischaracterization of Australian development, enhancement, maintenance, protection, and exploitation (DEMPE) activities; and
2. Arrangements involving the nonrecognition of Australian DEMPE activities.

The first identified arrangement is described as follows:

- Old arrangement: an Australian company owns intangibles, derives income from the exploitation of those intangibles, and performs the DEMPE activities;
- New arrangement: the Australian company reduces its DEMPE activities in respect of the existing intangibles. The company enters into a contract R&D arrangement with an international related party (ForCo) to provide services to ForCo associated with the DEMPE activities in respect of new intangibles. The new intangibles are "intrinsically linked" to the existing intangibles, and the Australian company is remunerated on a cost-plus basis. Under this arrangement, Australian-based intangibles decline in value and non-Australian-based intangibles increase in value.

It is noted that this arrangement has similarities with intangible migration scenarios provided by the ATO as part of the Practical Compliance Guideline (PCG) 2018/5, which considers the ATO compliance approach in respect of the diverted profits tax (DPT).

The second identified arrangement involves the nonrecognition (or under-recognition) of Australian DEMPE activities, the exploitation of the intangibles by international related parties in a way in which the Australian entity does not receive an appropriate share of the income associated with the intangible.

These examples consider more complex transactions including cost contribution arrangements (CCAs) and less traditional forms of intangible assets, such as online databases of know-how. Such considerations have a broad implication for multinationals when, for example, data relating to consumer behavior is increasingly valuable to successful business outcomes.

These arrangements may result in improper or non-arm's-length remuneration to Australian entities when significant substance or DEMPE activities are undertaken by that entity. Entry into such arrangements may also lack commercial rationale and not result in the best outcome for the Australian entity based on a consideration of realistically available alternative options and how an independent entity may be expected to behave in the same circumstances.

The potential consequences arising from the arrangements are stated to include:

- Failure to comply with the transfer pricing provisions in Division 815 of the Income Tax Assessment Act 1997;
- Failure to comply with Australian capital gains tax and capital allowances laws when intangible assets have effectively migrated as a result of the arrangement; and
- When the ATO forms a view that the requisite purpose of the arrangement is to obtain a tax benefit, the DPT provisions or general anti-avoidance rule may apply.

Next steps

Taxpayers that participate in or that are contemplating arrangements whereby they undertake activities in Australia using offshore intangibles should consider whether those arrangements are of the type described in TA 2020/1, or exhibit some of the features identified.

Advice should be sought on CCA contributions, which typically raise tax issues with complex characterization and benefit allocation aspects. In particular, arrangements with international related parties should be considered in the context of this Taxpayer Alert.

The ATO indicates that it is currently undertaking compliance activity in respect of such arrangements and is continuing to develop its technical position in this area. It is understood that the ATO is currently developing a PCG to outline its compliance approach in respect of intangible arrangements. Taxpayers that the ATO considers as higher risk will be subject to increased scrutiny. The ATO is encouraging affected taxpayers to engage with the ATO to discuss their situation.

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Israeli court supports taxpayer’s business model change

Israel’s Central District Court ruled on 9 December 2019 that the fact that a taxpayer opts to enter into a related-party arrangement for the purpose of reducing business risk does not necessarily imply that it has executed a transaction that essentially embodies the transfer of “economic value” or an “asset.”

The ruling involved an Israeli taxpayer’s business model change in 2009-2010. The Israel Tax Authority argued that the taxpayer’s acquisition by a foreign multinational enterprise (MNE) group resulted in the sale of an Israeli asset subject to capital gains tax.

In 2009, the MNE group acquired the shares of the taxpayer and affiliated companies for USD 200 million. Following the purchase, the taxpayer entered into three agreements with members of the MNE group:

- A marketing services agreement: In 2010, the taxpayer agreed to provide marketing services and technical support to one MNE affiliate, a related company, on a cost plus 10 percent basis.
- A development agreement: Also in 2010, the taxpayer agreed to provide another member of the MNE group with development services on a cost plus 8 percent basis.
- A license agreement: Concurrent with the second agreement, the taxpayer entered into another transaction with a related Cayman entity under which it granted the Cayman affiliate a license to develop and sell products based on the taxpayer’s intellectual property (IP) in return for royalties ranging between 14.1% and 14.7% (as determined by a transfer pricing study).

Based on these agreements, the ITA contended that the taxpayer effectively transferred to the MNE group functions, assets, and risks (FAR) that constituted a transfer of business[2] outside of Israel subject to capital gains tax. According to the ITA, the market value of the taxpayer's FAR equaled the overall acquisition price of the company, USD 200 million before adjustments for other assets (for example, working capital). The ITA supported its position by pointing to several indicators of a sale associated with these agreements, such as the taxpayer's request to the Office of Chief Scientist (OCS) – the governmental funding agency for many technology start-ups – characterizing the license agreement (the third transaction) as a "sale" of IP and not as a license of IP in exchange for royalties.

In its response, the taxpayer argued that the ITA's description of the related-party agreements as the transfer of a business mischaracterized the transactions. As evidence, it noted that following its acquisition, its financial situation improved, with income and profits rising and its workforce expanding. Further, it earned significant royalties from its license agreement and additional revenue on the subsequent sale of its remaining IP. With respect to its request to the OCS, it noted that the reference to "sale" of IP was in keeping with that governmental agency's terms of art when considering transfers of IP outside of Israel.[3]

Court decision

The court accepted the taxpayer's account that changes to its business model did not represent a sale of business or of IP. In formulating its position, the court touched on several matters that are frequently addressed by the ITA in its analyses of MNE acquisitions of Israeli start-ups, including the following:

Court clarification of previous court decision. In reaching its conclusions, the court referred to a 2017 court ruling (with the same judge presiding) also involving the purchase of an Israeli company, in which actions subsequent to the acquisition led to the Israeli company being transformed into a "meaningless corporate shell" and the Israeli affiliate failing shortly afterwards. The court highlighted the differences between the facts and circumstances of the earlier case and those concerning the taxpayer and the MNE group and noted, in particular, that the taxpayer's operations in the current case in fact had expanded. According to the court, "the mere fact that a business decides to mitigate risks does not mean that it has executed a transaction essentially embodying the transfer of economic value or of an asset." Similarly, the court rejected the ITA's contention that transition to a "cost plus [markup]" relationship with a related party is necessarily equivalent to the sale of a valuable asset. Instead, the court accepted as a reasonable proposition the notion that taxpayers may alter their functions, assets, and risks so as to improve their likelihood of financial success.

Court acceptance of basic concepts applied to cost sharing arrangements. The ITA challenged the taxpayer's position that as part of the changes to the taxpayer's FAR, the related Cayman affiliate would own all newly developed IP and bear the associated business risks while the taxpayer's legacy IP would be retained by the taxpayer and licensed to the Cayman entity. In asserting its claim, the ITA maintained that the license of the legacy IP was equivalent to a sale that would leave the Israeli taxpayer stripped of any know-how. The court, however, dismissed this claim, noting that the taxpayer's R&D workforce had expanded following the acquisition and, more importantly, subsequent to the licensing arrangement, the taxpayer was able to sell its legacy IP to a third party for USD 73 million, making the ITA claim unconvincing to the court.[4]

Court view of changes to functions, assets, and risks. As transfer pricing guidance has been interpreted heretofore in Israel, changes to FAR may serve as a reference point for transaction pricing even in instances that do not appear to involve the explicit transfer of an asset. Given fairly broad definitions of "property" and "sale" in the Israeli tax regulations, the court accepted the premise that changes to FAR may serve as an indication that property has been transferred. Notwithstanding this interpretation of changes to FAR, the court found that the fact that the taxpayer's development employees and marketing employees subsequent to the acquisition continued to undertake development of technical and marketing IP (on behalf of the MNE group) – albeit with less risk and less "upside" potential – meant that these activities remained with the taxpayer.

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[2] In the court's words, "the essence of things, the lifeblood of the appellant and the core assets."
[3] The taxpayer also disputed the manner in which the ITA computed the value of the IP, but the matter of the ITA's computation assumptions was not a principal focus of the court decision as it focused largely on whether there had been a business transfer altogether.
[4] Additionally, prior to the sale, the taxpayer earned USD 137 million in royalties.

In this regard, the court held that, in accordance with the OECD transfer pricing guidelines, consideration must first be given to the legal agreements among the related parties and to the accompanying intercompany pricing and the conduct of the related parties to ensure that the pricing is arm's length.[5] Although it is within the tax authority's mandate to reexamine cross-border transactions between related parties, it should only recharacterize the intercompany agreements as different transactions sparingly. According to the court, in the case of the taxpayer and the MNE group, the various business changes the ITA cited did not represent a transfer of business.

Court recommendation on the status of OECD guidelines

The court observed that although the OECD transfer pricing guidelines have not been officially adopted in legislation in Israel – and some portions of the guidelines were added subsequent to the conclusion of the transaction in question – the OECD guidelines nonetheless may serve as a guide to the ITA in evaluating cross-border transactions between affiliates.

Although in the court's opinion the taxpayer's restructuring activities (as evidenced by the changes to its FAR) did not result in a sale, thereby obviating the need to examine any valuation issues, the court offered comments on the following related matters:

Payments made to the Office of the Chief Scientist. As noted, Israeli start-ups often take advantage of favorable financing and tax treatment offered by the OCS to encourage R&D within Israel. The OCS incentives package includes a requirement that any know-how developed using the OCS funds must remain in Israel or may be transferred outside with repayment of principal and interest plus a sizeable penalty. Recognizing that most MNEs acquiring Israeli start-ups intend to arrange for the ultimate transfer of the Israeli IP, the court viewed the penalty repayment as a precondition for the acquisition and thus another element that would be factored into the acquisition price the MNE group paid for the taxpayer (and its affiliates).

- **Reliance on purchase price allocation (PPA) documentation to value tax assets.** Concerning valuations of tax losses that were to remain the taxpayer's, the court declared that while it does not consider PPAs to be a sufficiently precise tool to determine market prices for tax purposes, in the absence of other reliable information, they may serve to clarify at least how one side considered the value of certain assets at the time of an acquisition.
- **Valuation of workforce in place.** Evaluating the claims made by the ITA (which chose to apply a technology sector discount rate to discount the cash flow associated with the taxpayer's employees) and the taxpayer (which applied a much lower discount rate to reflect the fact that the business risks of the taxpayer would be much reduced in the future with the transfer of most of the business risk to other MNE affiliates), the court noted the inconsistency of the ITA's position which, on the one hand, maintained that the taxpayer had been stripped of most of its value but, on the other hand, chose to apply a high discount rate.
- **Royalty rate charged on legacy IP retained by taxpayer.** The taxpayer applied a constant royalty rate in line with its position that the old knowhow would retain value indefinitely, which the ITA disputed. The court found that the longevity of the taxpayer's IP was strictly a factual matter and required evidence to resolve this matter.

Commentary

The District Court findings represent an important breakthrough for taxpayers acquired by foreign MNEs, and unless the ITA appeals the decision to the Israel Supreme Court, offer support for certain business arrangements entered into in recent years that are presently under examination by the ITA. Most significant among the court's many pronouncements was its conclusion that the mere fact that a taxpayer opts to enter into a related-party arrangement for the purpose of reducing business risk does not necessarily imply that it has executed a transaction that essentially embodies the transfer of "economic value" or an "asset."

In its general guidance offered to the taxpayer and the ITA and to other interested parties, the court viewed favorably the positions adopted by the OECD in its revised transfer pricing guidelines incorporating directives adopted in the base erosion and profit shifting (BEPS) final reports, which may be regarded as a favorable turn of events. MNEs seeking to restructure an Israeli entity's business activities following its acquisition would be advised to take note of

[5] Making reference, in particular, to OECD Guidelines paragraphs 1.42, 6.34, and 9.168.

this ruling alongside the 2017 ruling and to consider the degree of change to the local operation subsequent to the business model change (in particular, whether the workforce in place, sales, and profits, expanded or contracted following this business model change).

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Qatar introduces transfer pricing regulations

The State of Qatar recently introduced new transfer pricing regulations, which are applicable for accounting periods ending on or after 31 December 2019. Qatari entities with a 31 December year-end must complete a transfer pricing form/questionnaire, which is due by 30 April 2020. A local file and master file must be in place by April 2020.

Background

The newly introduced transfer pricing regulations are part of the Executive Regulations to the Income Tax Law No 24 of 2018, published in Qatar's official gazette on December 11, 2019, and reflect Qatar's commitment to implement the OECD's Action 13 for accounting periods ending on or after 31 December 2019.

The new transfer pricing requirements include five elements in the compliance process:

1. A transfer pricing form/questionnaire must be provided with the tax return (due in April 2020);
2. A master file must be in place by April 2020 – the multinational entity (MNE) group's master file will be sufficient for these purposes;
3. A local file must be in place by April 2020 – the General Tax Authority (GTA) will confirm over the next month whether this needs to be filed with the tax return;
4. Country-by-country (CbC) reporting requirements (already introduced in 2018/2019); and
5. A requirement to obtain approval from the GTA if the taxpayer is not applying the comparable uncontrolled price (CUP) method for intragroup transactions involving Qatar.

Additional guidance is expected to be issued in due course to clarify key areas. This will include an advance pricing agreement (APA) program that will become available to taxpayers involved in complex and material transactions. There will also be a materiality threshold or an exemption, but no further information is available.

While the GTA has not specified any penalties for failure to comply with the new regulations, the tax authorities retain the right to impose a penalty up to the maximum amount of QAR 500,000 (approx. USD 138,000) for noncompliance.

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Chilean tax authorities sign first-ever APA

Chile's Internal Revenue Service (CIRS) and the National Customs Service (NCS) recently entered into the country's first-ever advance pricing agreement (APA) with a taxpayer. Interestingly, this APA is also the first one in the world in which the country's customs authority was a party to the agreement.

The signing of the APA marks a milestone that may be of interest not only to national tax and customs authorities, but also to taxpayers who seek to increase their tax certainty and avoid potential transfer pricing audits and litigation. APAs also may reduce the possibility of double taxation and constitute an opportunity for tax administrations and taxpayers to consult and cooperate to reach an agreement.

Deloitte Chile's Transfer Pricing team conducted the negotiations with the tax authorities that resulted in the signing of this agreement.

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Financial Services Transfer Pricing: Outlook for the asset management sector for 2020 and beyond

Asset managers are fundamentally transforming the way they work. Key triggers are new fee arrangements, clean share classes, and the unbundling of fees, which will require tax departments to examine the potential impact on fee flows, existing transactions, and transfer pricing policies, as well as the availability of fee data for benchmarking purposes. The continuous progress of technology also raises the question of how to structure such investments from a transfer pricing perspective with respect to the ownership and use of the resulting intangibles.

This article examines two key trends and the impact on transfer pricing that the asset management sector will need to keep on the radar for 2020 and beyond. On the one hand, new fee arrangements, clean share classes, and the unbundling of fees will require tax departments to examine the potential impact on fee flows, existing transactions, and transfer pricing policies, as well as the availability of fee data for benchmarking purposes. On the other hand, technology continues to be a game changer in the financial services sector, requiring massive investments, and raising the question of how to structure such investments from a transfer pricing perspective with respect to the ownership and use of the resulting intangibles.

Key Trends

As mentioned above, asset managers are fundamentally transforming the very way they work – this is true for the rise of new charging structures, share classes, fund platforms, and distribution models, as well as the ever-increasing importance of technology, such as artificial intelligence, big data, and robo-advisors, impacting key aspects from investment management to regulatory compliance or customer experience.

Charging structures and platforms

Over the last few years, regulatory changes (especially on inducement regimes) have affected the charging structure of investment funds and led to a rise in new share classes such as clean shares. Clean shares have no loads, commissions, or other distribution fees, which typically pay for an investment fund's distribution costs, and no platform fees.

One of the triggers were rule changes first introduced in 2013 as part of the Retail Distribution Review (RDR) in the United Kingdom, which banned the commission payments that were received by fund managers when recommending their products. As an example, investors using an online broker will therefore often find themselves investing in commission-free funds via so-called "clean" share classes. The investors will then typically pay a separate service fee to their broker. Similarly, those who use a financial advisor could be charged separately for services received.

MiFID II, which was rolled out in 2018, placed additional restrictions on inducements paid to investment firms or financial advisors by any third party in relation to services provided to clients. Clean share classes emerged as a MiFID II-compliant response to the ban on inducements. Nonetheless, the rise of new share classes has led to an increased complexity in operations.

In sum, three different charging structures can be observed in the asset management sector:

- Unbundled: An investor pays only for investment management and fund operating expenses, and the fund and its advisor do not pay third parties who sell their funds to the public. Instead, distribution, platform, and other operational fees would be charged directly to the investor under a new service-fee arrangement;
- Semi-bundled: The fund charges do not include traditional loads, commissions, or other distribution fees, but can include platform fees, for example. Again, distribution and certain other operational fees could be charged directly to the investor under a new service-fee arrangement; and
- Bundled: Traditional share classes whereby the asset manager pays intermediaries out of the fee charged by the fund and that contains all fees for distribution, platforms, and other operational expenses.

From a transfer pricing perspective, this implies that asset managers will need to take into consideration the impact of new fee arrangements, share classes, and the unbundling of fees. Most notably, there is a potential impact on existing fee flows, transactions, and transfer pricing policies (especially fee splits and the fee basis for the split). This trend could also affect the availability and applicability of both internal and external market data for benchmarking/testing purposes.

Asset managers increasingly rely on fund distribution platforms. These platforms work as intermediaries between distributors and asset managers, serving administrative functions such as order routing and settlement, data processing, rebate calculations, compliance, and managing distribution agreements. In a post-MIFID II environment, where rebates are no longer the norm in some markets, platforms are rebalancing fees more evenly between distributors and asset managers, with both sides paying for the service they use. In addition, fund distribution platforms are also increasingly replacing traditional intermediaries.

An intermediation fee is taken as a portion of a distributor rebate – when still relevant – while distributor fees and new explicit "platform services" fees based on Assets under Administration are paid by asset managers. In Europe, fund platforms are trying to replace rebates with explicit fees to asset managers, charged on top of clean share classes. Again, tax departments will need to assess the potential impact on existing fee flows, transactions, and transfer pricing policies.

Technology

Technology continues to be a game changer in the financial services sector. Examples include the rise of robotics and automation-related technologies to reduce operating costs, algorithmic models that evolve from internal risk management tools to key portfolio management tools, to robo-advisors and artificial intelligence facilitating investment decisions and product selection. The future will entail using digital technologies to automate processes, improve regulatory compliance, transform customer experience, and disrupt key components along the value chain.

This technological upheaval continues to require heavy investment and raises the question of how to structure such investments, from a transfer pricing perspective, with respect to ownership and the use of the resulting intangibles within the group. The essential question is whether technology needs to be characterized as a key intangible for tax purposes going forward, which also requires a change to existing approaches for the tax treatment of development expenses. The result could be that an allocation of development costs via service (re-)charges is no longer appropriate, but instead a license fee/royalty model needs to be introduced to remunerate the owner of the intangible(s) for the development activities.

Consequently, financial institutions will need to do the following:

- Reexamine the existence of potential intangibles in light of the broader definition under OECD BEPS Action 8 and the use of such intangibles (also in the context of branches and attributing potential expenses or license fees under the new OECD separate entity approach);
- Revisit existing transfer pricing positions regarding remuneration for the use of intangibles, depending on the financial benefit or whether related costs should be included in internal cost recharges;

- Identify all relevant intangibles and their use in transfer pricing analysis/documentation, even if use of those intangibles is not being remunerated (with supportive argumentation for non-remuneration);
- Track development activities, especially if performed out of certain (pioneer) locations and decide if strategically development activities should be centralized in one location to also centralize the ownership of intangibles in that jurisdiction;
- Confirm consistency between tax-related and other messaging (especially for investor relations and regulatory purposes); and
- Review the appropriateness of existing transfer pricing documentation and intercompany agreements.

Conclusion

The tax function of asset managers should be actively involved in addressing the tax implications arising from new charging structures, share classes, fund platforms, and investments in technology. Tax departments may need to assess the potential impact on existing fee flows, transactions, and transfer pricing policies, as well as how to structure investments in technology from a transfer pricing perspective with respect to the ownership and use of the resulting intangibles.

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