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No 82

Technology, Media and Telecoms

(1st Edition)

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International Tax Review is published 10 times a year by Euromoney Trading Limited, London.

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ISSN 0958-7594

Digital revolution – Spotlight on tax and TP issues in TMT

Todd Wolosoff, global
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On behalf of our Deloitte tax colleagues that focus on tax and transfer pricing issues within the technology, media and telecommunications (TMT) industry, we are pleased to present this selected collection of thought papers on industry developments and issues.

While many readers may have some knowledge of issues within this industry, we know that one of the key challenges that the TMT industry faces is addressing the breadth of significant tax, transfer pricing, and restructuring issues that are specific to it. Therefore, we begin our guide with a primer on the media and entertainment industry supply chain ranging from production, distribution (theatrical, home entertainment and streaming) to pipeline and packaging, and follow on with an overview of the potential opportunities and pitfalls as a result of the telecom convergence. We address transfer pricing fundamentals, and transfer pricing issues specific to the TMT industry in an attempt to broaden the general knowledge base of international tax professionals or others interested in this revolutionary industry as it is going digital. Next we turn our attention to the challenges of implementing and tracking transfer pricing policies in the continuously evolving technology sector. We have also included an overview of recent tax developments for selected countries that have a significant or expanding presence in today's TMT industry, and address location specific advantages in places like China and India. Finally, we highlight the importance of building a flexible global business platform from an international tax perspective and comment on the VAT consideration for e-commerce.

Given the complexity and variety of tax issues within this industry, this guide should be the starting point rather than the finish line for your TMT industry related transfer pricing and tax inquiries. For more information regarding transfer pricing issues in specific countries, and about Deloitte's tax practice in those jurisdictions, please refer to the list of Deloitte member firm contacts contained in Deloitte's 2013 *Global Transfer Pricing Country Guide*, which can be found at http://www.deloitte.com/view/en_GX/global/services/tax/cross-border-tax/transfer-pricing/87f08ed08affd110VgnVCM100000ba42f00aRCRD.htm

We hope you find our publication interesting and, more importantly, of practical use, and we invite you to contact our leading team of professionals or your local Deloitte contact if you have any questions.

Yours truly,

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Experience

Todd Wolosoff is the global and US managing partner for Deloitte's Transfer Pricing Group, and a tax partner in the New York City office. He has over 25 years of experience as a partner in representing multinational corporations in transfer pricing and international tax matters. Todd was promoted to his current roles in 2012 and 2011, respectively. Previously, Todd was the partner-in-charge of transfer pricing for the northeast US and the leader of the Tri-State Transfer Pricing Group since its inception in 1990. He is a founding member of the Deloitte Tax National Transfer Pricing Leadership Group.

In Todd's global leadership role, he is responsible for creating and implementing strategy and providing vision and leadership to Deloitte's nearly 2,000 transfer pricing professionals worldwide. Todd also serves as the leader of the Global Transfer Pricing Leadership Group that meets actively throughout the year. Todd is also an active member of the DTTL Global Services Council.

In Todd's US transfer pricing leadership role, Todd is responsible for all aspects of the US Transfer Pricing Group including strategy, operations, hiring, and human resources. Todd has approximately 50 partners, principals, and directors, and hundreds of professionals as part of his team. Todd is the leader of the US Transfer Pricing Leadership Group, and is an active member of the Deloitte International Tax Leadership Group and the Deloitte US Tax Executive Group.

Todd serves as an adviser to several of the world's largest multinationals and has conducted numerous transfer pricing planning studies in virtually all industries, with a particular focus on pharmaceuticals, electronics, financial services, consumer products, automotive, TMT, and fashion and beauty products for both inbound and outbound taxpayers. He has been recognised by Euromoney as one of the world's leading transfer pricing advisers in each of the years the survey has been conducted, and was one of four Deloitte Tax partners selected by Mondaq in its survey of the top attorneys in the US. Todd is also recognised by the International Tax Review as one of the world's leading tax advisers.

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Kristine has with her international background and experience working in Deloitte transfer pricing teams in Copenhagen and London build up an extensive knowledge of global transfer pricing matters. Kristine is the Americas transfer pricing leader of the Technology, Media & Telecommunications industry programme. She assumes the global lead tax partner role for the World's largest container shipping conglomerate, the global lead TP role for a U.S. based Media Conglomerate and the U.S. lead TP role for the largest European headquartered Consumer and Industrial Goods Conglomerate.

Kristine has given numerous speeches and presentations at the American Conference Institute, Tax Executives Institute, BNA, Atlas, Thompson Reuters, CITE, Deloitte Debriefs and Conferences on transfer pricing issues.

Prior to joining Deloitte, Kristine was an international tax manager at Andersen's Copenhagen office. Before joining Andersen, Kristine worked at the European Commission in Brussels in the Cabinet of the Danish Commissioner for Energy and Nuclear Safety.

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How understanding business will reduce controversy

Keith Reams explains the importance of understanding the business to successfully navigate TP controversy in TMT.

Technological innovation has been the defining economic force in the world for the last century, leading to profound advances in how individuals interact with the world. Likewise, companies have had to constantly adapt to new realities to produce their products, reach their customers, and develop the next generation of products. However, innovation has not been the only factor influencing companies; faster technology life cycles, constant declines in average selling price, and a growing field of competitors also have had a direct impact on revenue growth and profits in most industries. Together these forces have reshaped how companies organise themselves; specifically, the emphasis has been on forming enterprises that are truly global in scope, but nimble enough to respond to local preferences. For many multinational companies, this has meant moving manufacturing to less developed regions of the world in search of lower costs, while continuing to market and promote products in traditionally developed markets. Similarly, companies have been developing R&D resources wherever they can find a pool of qualified and skilled people.

Governments and their tax systems, unfortunately, have not kept up with these trends, and multinational enterprises are increasingly finding themselves embroiled in controversy. In particular, long and protracted disputes over how companies allocate their global profits between their marketing, technology, and manufacturing functions are becoming the norm. One of the reasons for this imbalance is that the international tax system was established for a different business environment. Use of a largely outdated system to tax global enterprises competing in a rapidly changing global business environment has led to costly and inefficient controversy.

International tax system's origin and the shift away from that system

The international system of taxation was established at a time when simpler business models prevailed. Half a century ago, the economic factors that affected companies were usually local. Moreover, a business was typically functionally clustered together, because development, manufacture, and sales were most often performed in the same country, or at most geographically distributed among countries in close proximity. Foreign operations tended to be minimal, and companies relied on imports from third parties when necessary. Foreign markets were important primarily as sources of raw materials to be imported for home country production. The international taxation system was consequently much simpler. This system worked for many years without major issues, as long as foreign operations did not take on economically significant importance and the core business functions remained in the domestic operations.

Thanks to ever-faster forms of communication and transportation, the distance between countries seemed to shrink, and companies began to view foreign operations not just as sources of raw materials but also as sources of growth. To capitalise on

these markets, companies typically had two options: (1) manufacture the product in the home country for sale into foreign markets by shipping them to either a third party or a related party for resale; or (2) manufacture the product in the foreign market for resale locally or regionally, reselling through either a third party or a related party. This shift abroad was also motivated by an effort to reduce costs in the face of aggressive competition. While consumers gained through declining prices, companies underwent significant reorganisations of their business models to keep up and stay in business. To maintain profits, a purely domestic company serving global markets had two choices: innovate constantly to sustain pricing power or reduce costs to compete on price. For many companies, the immediate answer was to lower the costs of manufacturing product by moving abroad, and innovation was a necessity.

As more production activities shifted to foreign locations, most often to Asia, the manufacturing supply chain shifted as well. Logistics became more complex and costly, both in terms of transporting goods and time spent managing the chain. Given the complex and increasingly “we want it now” demands of end consumer markets, time to market became the factor that could make the difference between success and failure. In response, supply chains have tended to become more closely clustered together, so that production can be scaled more quickly. This is one of the advantages of the typical Asian supply chain: suppliers are clustered closely together and top level manufacturers are able to respond quickly to sudden shifts in demand.

Also driving the shift of production to foreign operations has been the declining demand for products in developed countries. The search for new customers has taken companies increasingly into the developing world. China and India have been prime targets for growth, given their billion-plus populations. However, many other emerging markets also have large populations, and may be even more desirable for future consideration. Today, many companies generate over half their revenue from their foreign operations.

These economic forces have driven many companies to realign their organisational structures from ones in which foreign markets were just a source of raw materials to structures in which foreign markets represent a strategic imperative for growth. In addition, companies have been taking advantage of the growing and now vast pools of skilled and highly educated labour in some foreign markets to establish centers of research and development. In realigning their structures to meet the new realities, companies have had to decide where to locate operations, and just how much function and risk to place in their foreign operations.

International tax regime

While companies have been reacting and building out their intercompany arrangements to reflect new business para-

digms, the international tax system has changed slowly, mostly through fits and starts. The system has evolved to produce one where taxpayers may face myriad overlapping and sometimes conflicting regulations and interpretations. This has resulted in an inefficient and costly system from the taxpayer's perspective. Frequent complaints have arisen from taxpayers about responding to increasingly expansive information requests that may not provide appropriate benefits, along with the perception that valuable time was lost that could be better utilised by focusing on the needs of the business.

During simpler times, the profit allocation among raw material suppliers and manufacturers and marketers was easily understood, as there were readily observable market prices for commodities. Thus, taxpayers generally relied on — and tax authorities generally endorsed — the use of the comparable uncontrolled price method to establish appropriate transaction prices. However, as functions and risks became more globally distributed, the question of intercompany pricing became murkier. Currently, not all types of intercompany arrangements that companies use have readily observable market prices. The testing of transfer pricing policies has accordingly shifted toward managing certain financial measures, such as operating margins or other financial ratios. This policy has produced new controversies over the issue of comparables. While reliance on comparable uncontrolled transactions has become less frequent in practice, some tax authorities continue to follow their historical preferred methods. Additionally, with tax authorities around the world recognising the increasing importance of transfer pricing and putting pressure on multinational companies, taxpayers may face multiple interpretations for the same transactions. Consequently, while the US may agree to contract development functions, another country may argue that more profit should be reported in its tax jurisdiction, perhaps because of the perceived higher value of the function or because the market itself may require an adjustment to account for lower costs.

Although the current debate in the press has tended to center on intangible property holding structures and concerns of base erosion, the underlying inefficiencies of the international tax system are felt by taxpayers. In addition to a time consuming process, litigation is complicated by turnover in corporate staff and managers. In today's world, it's not unusual for a tax authority to hold interviews with current employees that have no direct experience with what was happening in the business three years previously.

The appropriate response is often for the taxpayer to focus carefully on the underlying dynamics of the business. While not eliminating controversy, proper policies, procedures, and documentation often give taxpayers the ability to respond quickly instead of frantically catching up during an examination.

Evolutions on the horizon

Although many tax jurisdictions around the world have been scrambling to adapt to the realities of the global economy as it has evolved in the last three decades, global business in the second decade of the 21st century has continued to evolve, again creating upheavals in the international tax systems. New forms of market access without terrestrial geographic locations, such as cloud computing, and consumers that never stop moving are changing business paradigms that are likely to radically undo how companies have operated for the last 10 to 20 years. The personal computer market is currently undergoing a shift as tablet computers take share from traditional desktops and laptops. Additionally, delivery of products now occurs over a network, instead of a consumer taking possession of physical goods. Questions arise: if the product isn't different on the cloud as in the prepackaged box, how different is the organisational structure to support a hosted service? How does this change local sales? What does this mean in terms of competitive threats? How does the business respond in terms of functional responsibilities? How will tax authorities react when a transaction involves just design? How to address manufacturing that is not performed for global consumers, but for local tastes specifically? To what extent will global intangible property owned by one member of the group contribute to this manufacturing activity, or will all members act more or less entrepreneurially in their respective territories? The organisational changes that will be required to properly respond to these important questions are just beginning to be reviewed.

Today as more tax authorities around the world become more focused on intercompany transfer pricing, the importance of documentation has never been more important. The OECD's more recent work on issues of base erosion and profit shifting demonstrates the increasing pressure that multinational taxpayers are likely to face in the future, as governments move to create additional layers of regulation that will inevitably affect transfer pricing. With or without new regulations and guidelines from the OECD working group, taxpayers can expect more questionnaires and information data requests. Taxpayers must be ready with adequate support and documentation that tells a coherent story, so as not to be caught off guard and drawn into a potentially protracted period of controversy.

Biography



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Experience

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Keith has testified as a qualified expert in numerous valuation and transfer pricing disputes, including the cases of *Nestle Holdings Inc. v. Commissioner*; *DHL Corp. v. Commissioner*; and *United Parcel Service of America, Inc. v. Commissioner*. In addition, he is one of only three economists in the United States approved by the New York State Department of Taxation and Finance to provide transfer pricing expertise and testimony in cases involving cross-border transactions within commonly controlled affiliated groups. He has also helped many clients to successfully resolve valuation and transfer pricing disputes before they reach trial.

Keith completed course requirements for a Ph.D. in International Finance from New York University. He holds a Master of Arts in Economics from California State University Sacramento and a B.S. degree in Chemical Engineering from Stanford University.

Making technology work for your company

David Cobb, and Christa Silverthorne, in Deloitte's UK transfer pricing team, consider how the increasingly sophisticated capabilities made available by technology can work for or against companies, and highlight steps taxpayers should take to ensure that their policies are robust, relevant, and aligned with their commercial operations, and that on-going compliance is effectively monitored.

Multinational groups, particularly those operating in the technology and digital sectors, where a large portion of the value lies in intellectual property, are facing increasing scrutiny, suspicion, and public resentment about the levels of tax they pay. The OECD's ongoing base erosion and profit shifting project may lead to changes in the laws and available guidance, but in the meantime taxpayers need to focus on how well they have embedded their transfer pricing policies into their business functions.

Over the last few years, the global recession and consequent fall in tax revenues has led the world's NGOs, politicians, and media to focus on the relationship between revenues generated and corporate tax paid in their countries by multinational groups. Transfer pricing, and in particular the structures and policies adopted by companies in the technology and digital sectors, have received considerable attention in this debate.

One of the public challenges in the UK is that, whilst the taxable profits reported may be in accordance with current international tax laws, and so are not illegal, the resultant low levels of UK corporation tax paid (relative to UK turnover) are seen as potentially "immoral." Because of their high volume of trade with UK customers, multinationals are perceived to be benefiting from the UK infrastructure and economy without making a reasonable contribution to sustaining that environment.

After acknowledging that the international tax laws, treaties, and guidance designed by bodies such as the OECD and implemented by national governments have not kept up with modern technologies and commercial practice, governments have pledged support for an in-depth review of various key areas to address base erosion and profit shifting (BEPS). The areas to be worked on will be discussed at length over the next few months, but in the meantime companies need to consider whether the policies and practices they have in place to underpin their transfer pricing arrangements are being correctly implemented within their business by their employees.

Whilst each multinational's case will be dependent on specific facts, for technology and digital companies it is not uncommon for sales to customers in one country to be made by a group company in another country. It may also be the case that there are significant markets in some countries that have to be supported by substantial, valuable activities. Furthermore, underlying intellectual property may be a key driver of sales, and that property may or may not have been developed and owned in the same country as the sales. These fact-specific scenarios lead to questions regarding the value chain, focusing on the nature and importance of activities taking place in different locations, particularly where high-value activities and/or assets have been centralised or are in a low-tax jurisdiction.

Such business models, if implemented effectively, should fall clearly within international tax rules and transfer pricing guidance to support the allocation of taxable profits

between the relevant jurisdictions. However, with significant amounts of money potentially at stake, tax authorities are starting to focus increasing scrutiny on whether or not the people within each business are actually operating in accordance with their documented transfer pricing policies, or whether their activities in practice suggest a different allocation of profit.

Developing and managing transfer pricing policies

As part of the scrutiny of companies' activities, tax authorities, the media, and politicians are looking at all available public sources of information that may provide insight into where sales are concluded or other valuable activities take place. This includes all public statements made by the company but as has recently been observed, also extends to profiles of employees on recruitment-based social media sites where they describe their roles and experience. It is important to bear in mind that the main purpose of such sites is for people to advertise themselves through what is effectively an online curriculum vitae/resume. It would not be unusual for individuals to present their role and responsibilities in the most favourable light, and to make themselves appear to be more crucial to their employer's business than they actually are. However, these potential anomalies and inconsistencies could lead a tax inspector to conclude that there may be an argument for a greater allocation of profit to a particular group company, or for the existence of a permanent establishment.

So what could companies be doing now whilst waiting for the conclusion of the BEPS review to better position themselves with tax authorities? In the first instance, ensuring they have in place a strong transfer pricing control framework will aid in preventing and detecting issues, as well as providing a robust defence structure.

A good control framework includes clear transfer pricing policies; a record of any exceptions to those policies that prove necessary on implementation; identification of all transfer pricing stakeholders across the organisation; clarification of the responsibilities of these stakeholders; identification of transfer pricing risks faced by the business; and an effective method for communicating across all stakeholders.

It has always been important to make sure there are clear policies around activities, autonomy, when and where additional authorisation is required, etc. but taking active steps to engage and ensure that these policies are communicated to, understood, and accepted by the business people does not always get the attention it should. Identifying the key stakeholders in the tax and finance functions and within commercial teams, attributing responsibility for transfer pricing to them, and establishing a communication forum for this stakeholder group are critical to ensure that transfer pricing policies are followed as intended by the tax team. With the recent increasing profile of tax and transfer pricing policies it is essential to not only have such a stakeholder group in place but also to ensure it includes senior – ideally, board-level –

representation so that it carries the appropriate weight and influence within the group.

Using a structured discussion and communication forum during development of the transfer pricing policies will help ensure that those people setting the policies understand how the business needs to operate to be successful. It is very important that the commercial teams do not feel stifled by overly restrictive rules introduced to meet a tax objective, as that is when there is most risk of the policies not being followed and potential tax exposures arising. It is easy for a team that is disconnected from the day-to-day activities to devise rules that will deliver the lowest tax cost "within the letter of the law," but if this is not compatible with the way the business needs to operate, changes should be made even if this results in a higher tax charge.

Maintaining a dialogue between tax, finance, and commercial teams after the transfer pricing policy implementation is an effective way to ensure that the business continues to conduct its value-adding activities as documented in the transfer pricing policies or, where issues do arise, to make appropriate changes. It is the responsibility of all transfer pricing stakeholders to escalate concerns when reality does not meet policy.

Monitoring transfer pricing policy compliance

Creating or updating the group's social media policy is an excellent way to communicate the importance that people within the group not only demonstrate they are performing activities as per their role profile but also refrain from misrepresenting their role in a public forum. It is difficult to control what employees post on social media, but enforcing a social media policy with periodic reviews of what is being said about employee roles as part of a broader monitoring activity will help mitigate the risks of invalid information about the business circulating in the public domain.

Whilst comments made on social media can be discounted if they do not reflect the underlying business practices, tax authorities are increasingly using software tools to interrogate email systems and review discussions that might cast light on how a business actually operates. This could relate to a sales process, where absolute clarity around the responsibilities for marketing, opportunity development, negotiating, and concluding sales is critical to the outcome under transfer pricing principles, but also has significant impact in other areas such as intellectual property ownership and company residence.

Many businesses in the technology sector operate a policy of centralised intellectual property ownership, with the ongoing development undertaken by contract R&D entities or under a cost sharing arrangement. It is important for such groups to have key people involved in their intellectual property development and exploitation strategy located in the territory of ownership and to evidence that they are making key decisions. Technology, and in particular the ways people can

Biography



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now communicate, has blurred the lines around where board meetings are held, or where board members are when the meetings are held. This can then raise questions about where effective management and control (for purposes of establishing tax residence) is actually being exercised.

Periodic post-implementation reviews can help to identify any areas in which the business is not operating as documented, and to provide a clear indication of risk areas that should be addressed. Technology is providing new solutions that are ideal for scanning and analysing large volumes of data, and it is likely that many of these features are available on finance systems that are already running in house. If such facilities are not already available, groups should consider licencing the sort of software packages that are being used by tax authorities and many others to successfully extract key details such as decision making correspondence and travel details to monitor their own compliance.

In addition to reviewing compliance with the overall tax and transfer pricing policies, it is important to monitor individual companies' profitability levels, ideally on a dynamic basis during the year, to ensure they are in line with expectations. Processes for extracting and analysing the relevant data in an efficient, and ideally automated, way that minimises disruption and provides as close to real time information as possible are invaluable in avoiding surprises. To the extent the actual out-turn is not as expected or does not look appropriate given the overall fact pattern, a regular review during the year can ensure that anomalies or deeper issues are identified and dealt with appropriately and on a timely basis rather than as post-year-end adjustments.

A robust method of monitoring transfer pricing policy versus business operations and taking early action is the best defence. A software solution, such as an appropriate data analytics tool, may provide a useful way for the tax team to review past activities, monitor results on a dynamic basis, and also model the impact of future business change on current transfer pricing policies. Tools such as these can store the transfer pricing policy details and general ledger data that, when supplemented with actual invoices and any other business relevant data, make the continuous monitoring of policy versus reality possible.

Additional challenges

The technology sector faces additional challenges with monitoring compliance with transfer pricing policies because it is such a fast-moving industry with rapid changes in business models, new tools available to conduct business, and M&A activity that can change the profile of a group dramatically. These factors can have a significant impact on the tax profile of a group and introduce new commercial drivers that may render existing transfer pricing policies unsuitable or impractical.

Perhaps ironically, the tools and capabilities being made available by groups within the technology sector are providing tax authorities with significantly enhanced abilities to undertake in-depth audits, but they are also available for companies to use for their own pre-emptive monitoring. Using technology and keeping the lines of communication open between all stakeholders, with sufficient senior management involvement, is the safe bet for these times of increased scrutiny.

An overview of TP implications in the media supply chain

Kristine Riisberg and Anna Soubbotina provide an overview of TP implications in an ever-changing media and entertainment landscape.

The media and entertainment landscape is changing rapidly with the development and adoption of new technologies, continuing vertical integration and the advent of new business models. The corresponding supply chains and their transfer pricing implications are evolving as well. This article provides an overview of the main steps in the media supply chain, discussing their primary transfer pricing implications.

The media and entertainment sector consists of broad and diverse segments such as advertising and marketing, electronic games, information services, performing arts, and publishing and printing, each of which warrants individual analysis, as shown in Figure 1. While we will point out parallels with these industries throughout our discussion, our main focus will be the traditional media and entertainment industry consisting of the creation and exploitation of movies and other audio-visual content. Even within this simplified view of the media and entertainment industry, the complexity of the supply chain is such that identifying, characterising, and pricing intercompany transactions at each stage requires a deep understanding of the industry.

Overview of media supply chain

Many of the larger entertainment companies are part of diverse publicly owned companies that have operations ranging from movies to theme parks. Each entertainment company can be classified into one of the following categories: content creator, distributor, packager, or pipeline. (See Figure 3) Content creation or production companies produce movies, television shows, music, or combinations of such products. Distributors enable the public to access movies, television shows, and music through various channels including theaters, television stations, and retail stores. Packagers, usually television networks or stations, organise and schedule what consumers see and hear. Pipeline companies operate movie theaters, video stores, television systems, and internet businesses to physically deliver entertainment to consumers.

The largest entertainment companies typically straddle more than one category and operate multiple businesses. Thus, these companies are better positioned to utilise multiple means of marketing to promote their products and attractions. The larger, more established companies enjoy other advantages as well: larger companies in the filmed entertainment industry, for instance, have the ability to diversify their risk by developing a variety of projects and establishing stronger relationships with theater owners and TV networks. Larger companies also benefit from increased brand-name recognition, management experience, relationships with creative talent, and product distribution capabilities. The above factors contribute to the six largest film distributors making up 80% of US domestic box office revenues.

Figure 2 shows the scope of diversification and vertical integration of the largest

Figure 1

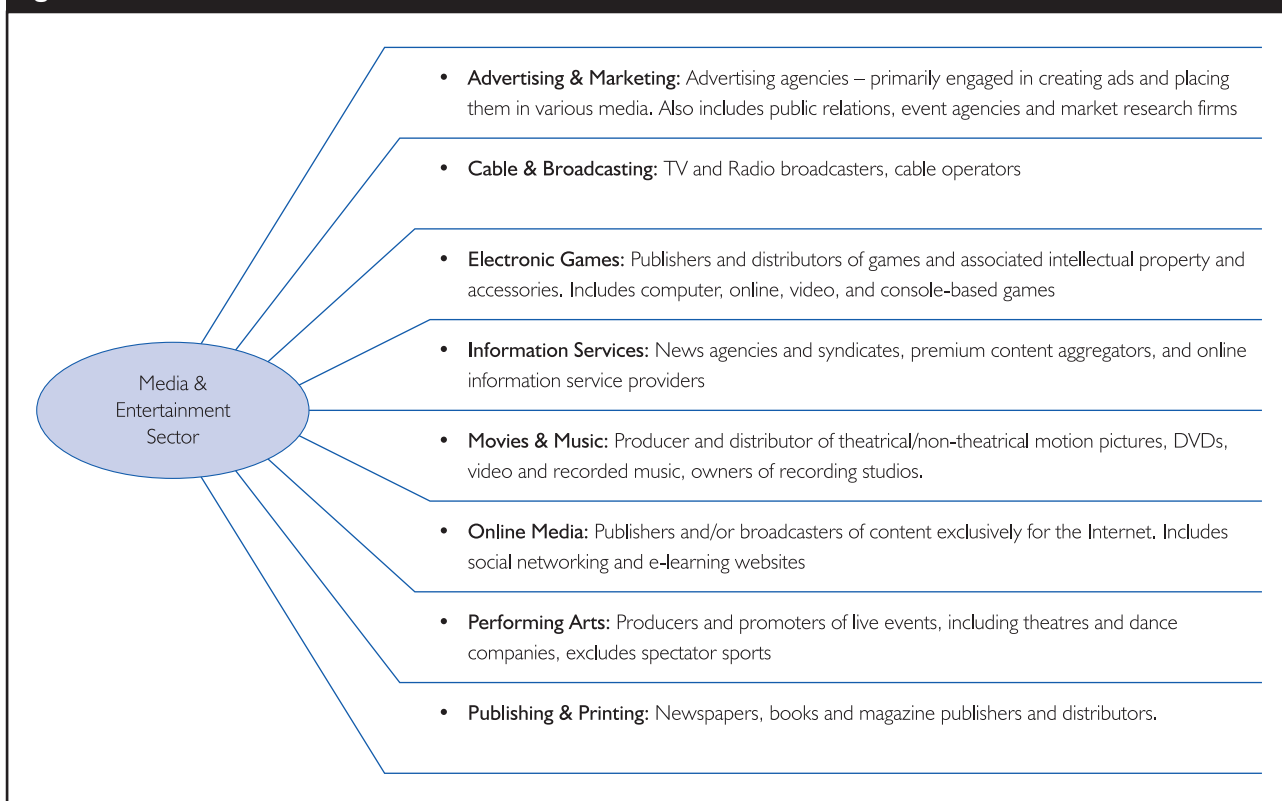


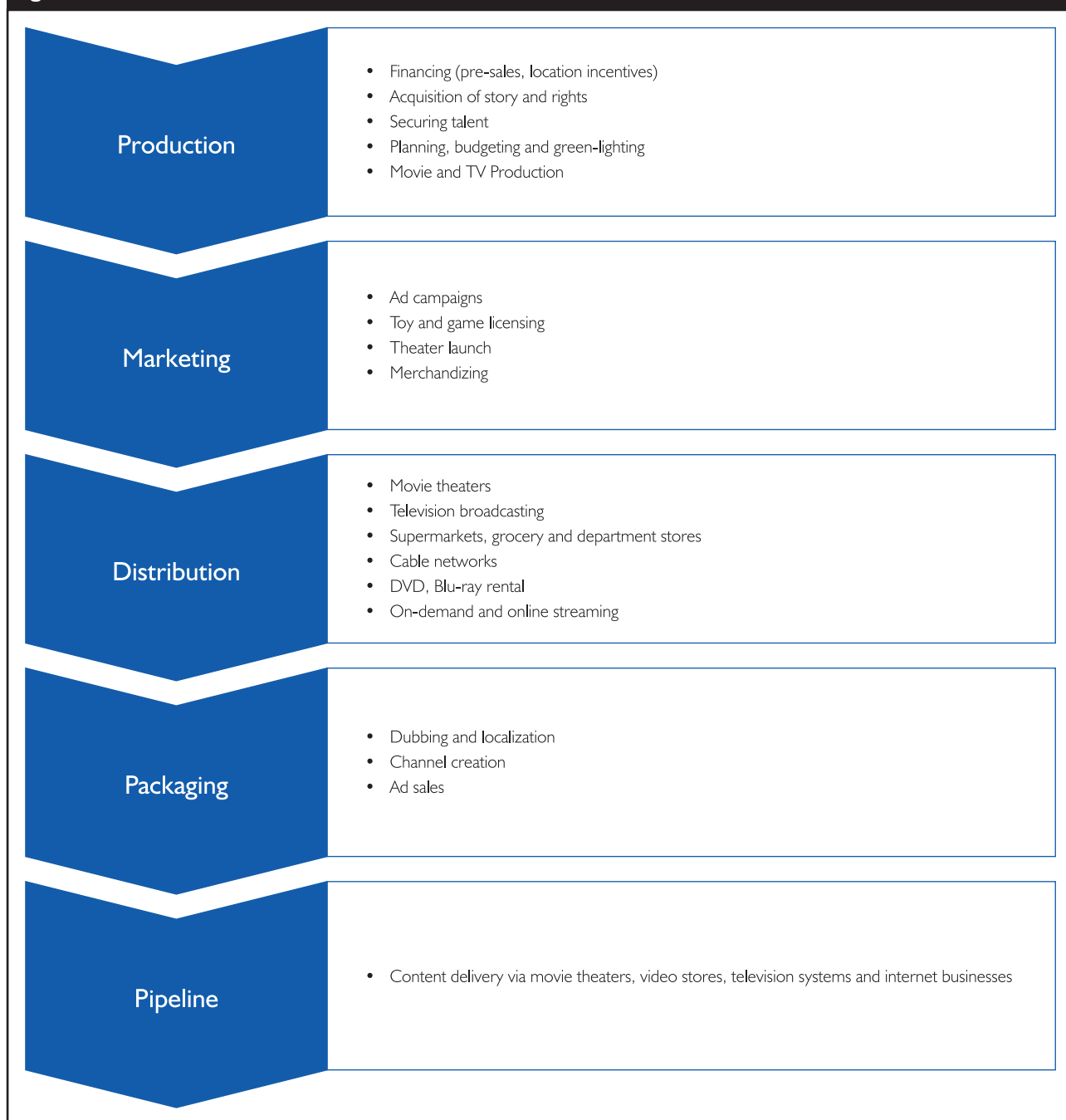
Figure 2: Diversified operations & assets of major media and entertainment companies

Company:	A	B	C	D	E	F	G	H
Basic cable Network(s)	•	•	•		•	•	•	•
Bill boards/Posters	•							•
Book Publishing	•	•	•	•				
Broadcast TV Network(s)	•	•	•			•		•
Broadcast TV Station(s)	•	•	•					•
Film Production/Library	•	•	•		•	•	•	•
Internet/Broadband Sites	•	•	•	•	•	•	•	•
Magazines/Newspapers		•		•		•		
Merchandising	•	•	•		•	•	•	•
Premium Cable Network(s)	•					•	•	
Radio Stations/Networks	•	•						
Recorded Music label(s)		•			•			
Theme Parks/Resorts		•	•					
TV Production/Library	•	•	•		•	•	•	•

Note: some relatively minor operations may be excluded. Includes significant equity interests in joint ventures or other companies.

Source: S&P Capital IQ Equity Research

Figure 3



companies in the industry, while Figure 3 illustrates the main steps of the media and entertainment supply chain.

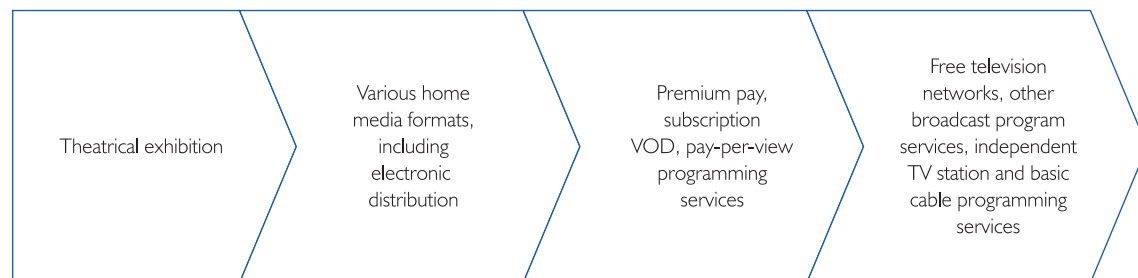
Production and marketing

Production companies create content by producing movies, television shows, music, or combinations of such products.

Proprietary content, such as movies or TV programming, is the intangible asset at the foundation of the media and entertainment industry.

The film production process begins well in advance of shooting the first scenes of a movie, at the preproduction phase. First, the rights to a story must be acquired, the screen

Figure 4



play written, the necessary talent secured, and the financing arranged. Once these pieces are in place, together with detailed cost and revenue projections, the movie may be approved for production, or “green-lighted”.

Production, also known as principal photography, is the actual shooting and recording of content. This is what most people imagine when they think of a film being made — actors on sets, cameras rolling, sound recording, and lighting. In large feature films, the production phase marks the point at which it is no longer financially viable to cancel the project.

The post-production process encompasses all the steps needed to go from production to a final master copy of a film, and may include adding special effects and sound track, editing, colour and exposure correction, processing and printing the film, or recording on digital media as theaters are increasingly able to project films digitally.

In addition to creating the content, the major studios also run large-scale publicity and advertising campaigns to create awareness and interest among the targeted consumer group. Such campaigns are critical not only for a film’s success in theaters, but also for driving future home video, licensing, and advertising revenues. The major studios carefully plan when, where, and how the movie will be released, starting with the day it goes to production, developing the two in tandem. The campaigns typically include television and cable ad spots and teasers in the coming attraction reels, and it is not unusual for studios to spend up to \$50 million in prerelease advertising on a single movie. In addition, studios can enter into promotional tie-in arrangements with fast-food restaurants, toy companies, and other retailers who provide additional advertising for related characters, toys, and video games.

The leading media and entertainment companies compile and maintain extensive libraries of proprietary content that continues to generate revenue for many years after the original release date.

Distribution

Distributors enable the public to access movies, television shows, and music through various channels including theaters,

television stations, and retail stores. The US is the lead exporter of TV productions in the world. In the European Union, for instance, more than 60% of broadcast TV content was produced in the US. Distributors alter much of this content before it is broadcast abroad to appeal to foreign audiences. Alterations are often done through dubbing and subtitles and can drastically change the original production to reflect local culture and jokes. These TV programmes are often considered coproduced by the original US producer and by the production company that adapts the content to be country-specific. As a result, revenue can be difficult to track, because it is accounted for by international distribution divisions and coproduction companies abroad. IBISWorld estimates that exports generated about 13.5% of the 2012 industry revenue.

The major studios derive motion picture revenues from four basic distribution sources, set forth in general chronology of exploitation in Figure 4.

For any given film, box office receipts and home video sales (both domestic and international) account for an overwhelming portion of gross revenues. However, other channels, such as TV licensing and pay-per-view, as well as emerging platforms such as video-on-demand (VOD) and Internet downloads, also contribute a meaningful portion of a film’s total ultimate earnings over its life span. Figure 5 summarises the industry’s primary box office and home video sources of revenue.

For movies exhibited in theaters, box office receipts are the most frequently published measure of success. However, those numbers do not tell the whole story and may be misleading without a more detailed analysis of the supply chain. First, movie theaters retain approximately 50% of the money that consumers spend at the domestic box office, passing the rest on to the distributor. The distributor, in turn, may deduct its prints advertising expenses, as well as a distribution fee of 15% to 30% of the total gross receipts for a movie. As a result, the studio receives only a portion of the revenue.

Take, for example, “Casino Royale” which was released in November 2006 and had a production budget of approxi-

mately \$150 million. The film's lifetime worldwide gross receipts were approximately 600 million.

600,000,000	Gross receipts
- 300,000,000	Retained by Theaters (50 percent of gross receipts)
- 43,900,000	Printing and advertising cost reimbursed to distributor
- 180,000,000	Distribution fee (30 percent of gross receipts)
- 150,000,000	Production budget
- 73,900,000	Profit/(Loss)

Six years after its original release date, the film may still be in the red based on theatrical revenue alone. However, with fewer intermediaries such as movie theaters, the studios typically receive a larger share of home video revenue, and rely on this and licensing revenues to make up for this shortfall.

Packaging

Packagers, usually television networks or stations, organise and schedule what consumers see and hear. Their activities include acquiring programming, compiling audiovisual content to form a cohesive programme, and digitally transmitting television programming to broadcasters. Packagers may also engage in the provision of limited format programming, such as news, sport, or educational content.

Pipeline

Pipeline companies operate movie theaters, video stores, television systems, and internet businesses to deliver entertainment to consumers.

Although physical home video sales have been declining since 2004 (and this trend is expected to continue), new ways to access video content are predicted to continue to compensate for this loss and lead to an overall steady combined market growth. Online video revenues have been increasing as a result of subscription-based services, and the VOD segment has improved thanks to more available titles, promotion campaigns, and day-and-date releases (which are simultaneous with the physical home video release). Electronic sell-through has also been increasing thanks to iTunes and similar services, though concerns exist over losing files and the ability to watch on multiple devices.

Digital media are projected to overtake the more traditional home video mediums within the next 10 years, digital downloads and VOD replacing physical home video products, and technology firms becoming increasingly intertwined with the media industry. The distinction between media and technology companies, between content and software, may become obsolete.

Transfer pricing implications

The most common intercompany transactions within the media and entertainment industry are the use of intangible

property, the provision of services, and distribution. In the following sections we will address the industry-specific aspects of these transactions for transfer pricing practitioners at each major step of the supply chain: production, marketing, and distribution. The packaging function is, in practice, often integrated into the distribution process and is discussed together with distribution activities. Further transfer pricing implications for the pipeline are considered in "Transfer pricing opportunities and pitfalls as a result of telecom convergence", also in this issue.

Production

IP and licensing

For the largest media companies, their global intangible property – content – is typically owned by a US parent and entrepreneur. Production for many of the companies is based in Los Angeles or similar locations, and cannot be easily moved. Furthermore, companies value the well developed and enforceable rules for patent and copyright protection in the US, relative to other jurisdictions.

A typical structure in the media industry is for a US affiliate to own the global IP and either license the foreign rights to this IP to its distribution affiliates abroad, or engage the marketing and sales services of these affiliates. Under the licensing scenario, several variations can be observed. The affiliates may license the content (movie, show), which is then shown in local movie theaters, or used to create a local channel. Alternatively, affiliates may license the distribution rights to a complete channel, as well as the rights to sell advertising on this channel. In both cases, the media companies frequently engage in similar transactions with unrelated distributors creating a large pool of potentially comparable market transactions that should be carefully evaluated for comparability with the intercompany licensing arrangements.

Under US Treas. Reg. §1.482-4(c), the comparable uncontrolled transaction (CUT) method evaluates the arm's length nature of an intercompany charge by reference to comparable uncontrolled transactions. If an uncontrolled transaction involves the transfer of the same intangible under the same (or substantially the same) circumstances as the controlled transaction, this method will ordinarily provide the most reliable measure of an arm's length charge. Circumstances are considered substantially the same if only minor, quantifiable differences exist for which appropriate adjustments can be made. Factors that are particularly relevant in determining comparability under the CUT method (besides the property itself) include contractual terms and economic conditions. For the intangible involved in the uncontrolled transaction to be considered comparable to the controlled intangible, both must have a similar profit potential, and be used in connection with similar products or processes within the same general industry or market. Other factors to be considered are the terms of the transfer, the stage of development, rights to

Figure 5

		Description	Revenue Driver Formula
Box Office	Admission	Tickets: a piece of paper used for admission into theatres	$(\text{Number of tickets sold}) * (\text{Average ticket price}) * (\text{Revenue share percentage})$
	Advertising	Online / Mobile: promotional campaign through internet or messages	$[(\text{Total ad views}) * (\text{Average ad CPM})]$ or $[(\text{Total ad clicks}) * (\text{Average click through price})]$
		On Screen: broadcasts amid movies in theatres and television	$(\text{Number of broadcasts}) * (\text{Average ad price})$
Home Video	Content	DVD, Blu-ray, and Cassette media storage formats: sale and rental	$[(\text{Number sold}) * (\text{Average sales price}) * (\text{Revenue share percentage})] + [(\text{Number rented}) * (\text{Average sales price}) * (\text{Revenue share percentage})]$
		Online/ Mobile downloads: transfer of audio/ video data from a host or server to a device	$[(\text{License fee}) + (\text{Number of downloads}) * (\text{Average download price}) * (\text{Revenue share percentage})]$
	Advertising	Online / Mobile: promotional campaign through internet or messages	$[(\text{Total ad views}) * (\text{Average ad CPM})]$ or $[(\text{Total ad clicks}) * (\text{Average click through price})]$
		In-video: broadcasts amid movies played through discs/ cassettes	$(\text{Number of views}) * (\text{Average ad price})$
	Consumer Products Licensing and Promotions	Earned by providing production intellectual property to third parties through consumer products licensing, game distribution, and promotions	$(\text{Licensed goods revenue}) * (\text{Royalty rate percentage})$

receive updates, revisions, or modifications, uniqueness of the property, duration of the license, economic and product liability risks, existence of collateral transactions, and functions performed by the transferor and transferee.

In the media industry, each intercompany and third-party licensing transaction is often individually negotiated considering a number of industry-specific factors. These may include viewer ratings, the star of the show, type of content (movie, series, documentary), whether the license includes rights to show on free or pay TV, whether the content has local or global appeal, the number of allowed reruns, as well as the date of the original release and age of the content. Furthermore, an evaluation of the profit potential of a particular movie or show should consider all potential sources of revenue, including theatrical, home video, and advertising over the term of the license or the life of the content.

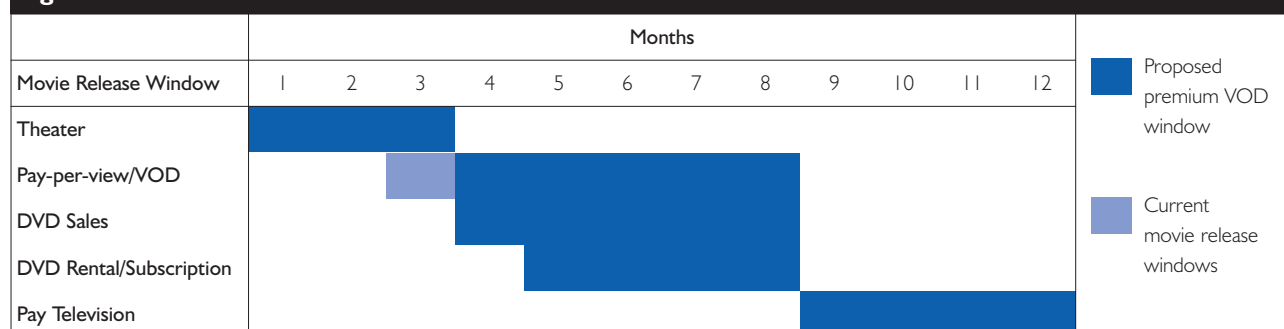
Production services

The tax and transfer pricing implications of film production are complicated, because it is common practice in the industry to set up separate wholly or partially owned production

companies for each film. The production company carries out all related activities as a service provider on behalf of the IP owner. Because many countries provide substantial tax and other incentives to attract the jobs and investment that come with film production, it is not uncommon for the production company to be located outside the US, giving rise to cross-border intercompany transactions. For example, the Canadian federal government provides a subsidy — the film production services tax credit — to qualifying foreign producers. In addition, British Columbia offers an 18% rebate on labor from that province. Finally, there is a 20% break in digital effects, if they are done in Canada. Other countries with specialised incentives for the movie industry include Germany, New Zealand, and the UK.

The comparable profits method is frequently applied to analyse the cross-border intercompany provision of production services. However, due to the specialised nature of the activities and the challenging economic environment for the media industry in recent years, closely comparable companies are difficult, if not impossible, to identify. Most independent production companies own significant intangible assets both

Figure 6



in the form of extensive content libraries and human capital. In addition, many independent studios are either undergoing financial restructuring or business consolidation. As a result, companies in the industry are often forced to rely on loosely comparable general service providers for transfer pricing purposes when analysing market returns for production services.

Marketing and distribution

Typical services include marketing and advertising, technical support, satellite and broadcasting, and equipment rental services. Distribution commonly involves the sale of content and advertising space. With most IP typically owned by the US parent, the most common challenge for the industry is to plan and analyse the appropriate amount of profit to be left with the non-US affiliates of the group, which are often regarded as either (1) distributors, paying royalties to the US entrepreneur and IP owner, or (2) limited-risk service providers. Furthermore, the question of whether local market insight and know-how constitutes valuable intangible property remains to be answered by the industry.

The functions and risks of the distribution affiliates within multinational media companies are changing with the transition from film prints and physical home video media to digital media. As digital media overtakes traditional home entertainment products, these companies will no longer need to maintain inventory of DVDs, cassettes, and Blu-ray disks to be shipped to video rental stores across the world, their country, or region. However, companies will still need to maintain relationships with their customers and gather valuable local market intelligence, as well as adapt centrally produced content before it is broadcast to appeal to local audiences. The transfer pricing implications of this shift from distribution to services activities should be carefully planned for, considering both US and non-US risks, compliance requirements, and opportunities.

Once an affiliate has been characterised as a distributor or service provider, the comparable profits method (CPM) is frequently applied to analyse the affiliates' profitability. However, due to the specialised nature of the activities and the media industry, closely comparable companies are difficult to identify.

CPM analyses are further complicated because media companies frequently operate a number of affiliates in the same country, whether for operational or historic reasons, with each affiliate specialising in a different distribution channel, such as theatrical, home video, or digital. In such cases, when multiple affiliates distribute the same content through different distribution channels in the same market, the inter-related nature of the revenue streams from theaters, TV channels and home video should be considered. Aggregating the financial results of these affiliates may more accurately reflect the complete supply chain of the media industry in a country for transfer pricing testing purposes. With the major studios having already shortened or considering shortening the release windows for different distribution channels, revenues from each are becoming more interdependent, with significant overlap in timing, as shown on Figure 6.

Finally, data from multiple years usually must be considered when applying the CPM. Generally, three years (the tested year and the two preceding years) of data are used, unless the specific facts of the case warrant a longer period. In the media industry, content can generate revenue for many years after its original release. The American television sitcom "I Love Lucy," which was originally launched in 1951, can still be seen on TV today and purchased on DVD and Blu-ray. Longer periods of analysis are therefore often appropriate to capture the full flow of returns in the media and entertainment industry.

Other transfer pricing considerations

Multistate transfer pricing

In the US, multistate transfer pricing issues can be significant for companies in the media and entertainment space. Most states offer special incentives to the film and television industry competing to attract the business and jobs from the production and distribution of films. Incentives may be in the form of tax credits, which can either be used or sold, or in the form of direct reimbursements of production costs. For example, beginning in February 2008, the Michigan film production credit provides a refundable, assignable tax credit of up to 42% of the amount of a production company's expenditures

(depending on type) that are incurred in producing a film or other media entertainment project in Michigan. In Arkansas, the Digital Product and Motion Picture Industry Development Act of 2009 created incentives for digital product and motion picture productions that include a 15% rebate on all qualified production expenditures made in Arkansas.

These incentives add further complexity to diversified media and entertainment companies' operations in most states. Transfer pricing is an issue in states that require separate filing for related, multistate corporations. Currently more than half the states that impose a corporate income tax require separate filing. With many states having adopted the Treas. Reg. §482 statutory language, multistate transfer pricing considerations, in the context of both content production and distribution, are of significant concern for the industry.

California, Hollywood's home state, has increased its emphasis on related-party audits involving foreign affiliates, and its auditors have been aided by various legislative and administrative changes. States such as California are now imposing penalties for failure to provide documentation supporting the transfer price reported on a return. In California, each taxpayer filing under the unitary method (including those making a water's-edge election) must maintain and make available on request books, papers, or other data affecting the calculation of a controlled taxpayer's true California taxable income. A taxpayer's failure to timely comply with an IRS request for documentation may result in significant financial exposure, according to Treas. Reg. §1.6662-6. California has adopted the relevant federal transfer pricing penalty provisions of Internal Revenue Code §6662, making the failure to comply with a Franchise Tax Board request for documentation likely to result in similar penalties. Therefore, media and entertainment companies should assess the need for more comprehensive documentation of their multistate intercompany transactions and policies.

Joint ventures

Major studios, which are primarily headquartered in the US, are expected to increasingly invest in developing markets to capitalise on audience growth in those countries. US production studios dominate the production and distribution of movies, and there are few entities outside the US that have similar production capabilities in terms of infrastructure, production financing, marketing, and distribution reach. However, the disposable income levels of consumers from rapidly developing, newly industrialised nations like Brazil, Russia, India, and China (BRIC nations) are rising quickly and expected to support industry revenue expansion of 1.5% in 2013. In addition, media companies are increasingly looking to use outside resources to expand their digital presence and the variety of content to offer as consumers' options expand. These factors contribute to the frequency of joint ventures in the media industry that can have transfer pricing implications.

China, for example, has until recently posed a myriad challenges for US filmed entertainment companies. Among such hurdles were censorship of content, protectionism, stringent media ownership caps and regulations for foreign-controlled entities, lack of legal and political transparency, cultural differences, bureaucracy, and piracy.

Now it appears that the Chinese market is becoming more welcoming to foreign studios. For instance, under its previous quota system, China allowed only 20 foreign film releases in its market each year, primarily outside of an imposed black-out period that coincided with popular movie-going seasons (such as, the Chinese New Year). However, following an announcement in February 2012 by Chinese Vice President Xi Jinping and his US counterpart Joe Biden, this limit was raised to 34 for films made in 3D or IMAX formats. China has also increased the share of earnings for foreign studios from about 13%–17% to 25% of the movies' box office sales in China.

Following these recent developments aimed at cross-country collaboration, the market has witnessed a flurry of deals in which US studios are entering into joint ventures with Chinese studios. For transfer pricing purposes in China, an enterprise and another enterprise, organisation, or individual are considered "related parties" if they have any of the following relationships, among others:

- A party directly or indirectly owns 25% or more of the shares of the other party, or vice versa;
- The party's production and business operations depend on the other party's patent, proprietary technology, or other licensing, etc.;
- The provision and receipt of services of the party are controlled by the other party.

As a result of this relatively stringent definition of a related party for Chinese transfer pricing purposes, many of the US studios' joint ventures with Chinese studios may qualify as related parties, and therefore may be required to comply with transfer pricing documentation requirements or be subject to penalties in case of an audit.

Industry-specific TP challenges

Companies in the media and entertainment space are facing unique industry specific transfer pricing challenges. Given the predominance of US IP ownership in the industry, it is important to focus on adequately planning for and documenting the profitability levels of non-US affiliates. Robust transfer pricing documentation may prove especially critical in mitigating foreign audit risk. In addition to IP transactions, particular attention should be paid to intercompany service transactions due of their specialised nature. Services such as content production, news gathering, and content localisation play a significant role and are often difficult to benchmark, requiring deep industry expertise to identify adequate comparables. Furthermore, the media and entertainment supply chain is

Biography



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Kristine is a Principal in Deloitte's New York office. She has more than 15 years of transfer pricing and international tax experience with Deloitte and spent four years in Deloitte's Washington National Tax Office. Kristine has extensive experience in company financial and quantitative research analysis and industry data analysis in a wide range of industries. She has prepared economic analyses, documentation, planning, competent authority requests and cost sharing studies for clients in the following industries: media and entertainment industry, telecommunications, digital, computer software, semiconductors, publishing, oil and gas upstream and field services sectors, power generation and renewable energy, chemical industries, healthcare and medical industry, financial services, automotive and automotive suppliers, quick service restaurants, travel industries, consumer goods, and commodities industries.

Kristine has with her international background and experience working in Deloitte transfer pricing teams in Copenhagen and London build up an extensive knowledge of global transfer pricing matters. Kristine is the Americas transfer pricing leader of the Technology, Media & Telecommunications industry programme. She assumes the global lead tax partner role for the World's largest container shipping conglomerate, the global lead TP role for a U.S. based Media Conglomerate and the U.S. lead TP role for the largest European headquartered Consumer and Industrial Goods Conglomerate.

Kristine has given numerous speeches and presentations at the American Conference Institute, Tax Executives Institute, BNA, Atlas, Thompson Reuters, CITE, Deloitte Debriefs and Conferences on transfer pricing issues.

Prior to joining Deloitte, Kristine was an international tax manager at Andersen's Copenhagen office. Before joining Andersen, Kristine worked at the European Commission in Brussels in the Cabinet of the Danish Commissioner for Energy and Nuclear Safety.

Education

- Graduate Diploma in Business Administration (Finance), Copenhagen Business School, 2004
- Master Degree in Laws (LL.M), University of Copenhagen, 1997
- Studied for her final major subjects at George Washington University – School of Business, 2004
- Legal studies at the University of Oxford, 1994

Biography



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Experience

Anna is a senior manager in the Global Transfer Pricing service line of Deloitte Tax, New York. She has seven years of specialised cross-border and multi-state transfer pricing experience, of which she spent two years in Deloitte's Washington National Tax Office.

Anna's experience includes managing projects in the following industries: consumer products, media and entertainment, energy and power generation, chemical, industrial equipment and automation, software, financial services, and healthcare. Anna has a proven track record consulting on a multitude of transfer pricing issues and the preparation of transfer pricing risk assessments under ASC 740, documentation, planning and audit defense studies, including cost allocation and services analyses, tangible and intangible property. Her focus is on intellectual property and cost-sharing projects involving the valuation of intangible assets, derivation of platform contribution payments and development of royalty rates for the use of intellectual property.

Anna manages and coordinates the preparation of global transfer pricing documentation for Deloitte Tax's largest clients, covering as many as 30 jurisdictions. Throughout this process, she ensures compliance with the US transfer pricing regulations, as well as consistency with the OECD guidelines. Anna works closely with Deloitte Tax's global network of specialists to bring clients the benefit of deep local country transfer pricing expertise.

Anna has designed and presented Deloitte Tax training on the following topics:

- Transfer Pricing Services Regulations, May, 2007
- Transfer Pricing and FIN 48, November 2008;
- Mutual Funds, A Roadmap of Transfer Pricing, August 2009;
- Introduction to Cost Sharing, April 2011;
- Intangible Assets and CUT Searches, October 2012.

Education

Anna earned her Master of Science in Finance from Imperial College London, UK and received a Bachelor of Science (Honors) in Economics from the University of St. Andrews, UK

continuously evolving and integrating with adjacent industries, as technology companies are successfully producing content and traditional media companies are acquiring hi-tech

distribution channels. These changes further underscore the importance of reviewing and reconsidering transfer pricing policies and documentation on a regular basis.

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TP opportunities and pitfalls as a result of telecom convergence

Peter Meenan and Ben Miller explain the evolution of the telecommunications value chain and the advantages and pitfalls that go with it.

The telecommunications value chain has fundamentally evolved in a way that has altered the transfer pricing landscape for taxpayers, creating potential tax planning benefits but also potential pitfalls and exposures for taxpayers who have not realised that the nature and value of their related-party tangible, intangible, and service transactions have likely changed from even a few years ago.

In the past, telecom services meant fixed-line voice analog telephone services through copper wires; today voice services are provided through fixed lines, wireless, or voice over Internet Protocol (VoIP) and the telecom service provider does not necessarily own the infrastructure necessary to provide the telecom services. One only needs to look at how integrated telecom service providers have expanded their service offerings around home security or even video, or the bundled price offerings for wired and wireless packages or a combined video, data, and phone service to see that the convergence around data and connectivity has shifted the potential value of intangible assets, as well as the potential risk associated with related-party transactions. In fact, from this integrated value chain perspective, integrated telecom service providers do not look that different from larger cable providers.

The complete value chain in telecommunications now includes providing connected and wireless solutions to residential and commercial customers, including prepaid wireless. The large telecom companies and their cable company competitors have integrated solutions along this complete value chain, allowing for bundled pricing of a greatly expanded portfolio of services often combining their own infrastructure with third-party-owned infrastructure to deliver the services. However, the telecom industry is distinct in that there are multiple companies that compete only in specific segments of the value chain. For example, infrastructure providers lease their capacity to wireless resellers and mobile virtual network operators, who focus their attention on gaining customers by selling their highly competitive services. Or VoIP competitors ride over the top of the infrastructure. This segmented nature of telecom provides transfer pricing insight into how arm's-length dealings may occur, and points to an indicative value for functions performed, risks borne, and assets employed in the industry.

We will review the current converged telecommunications value chain, paying particular attention to the value chain components that are often relevant for transfer pricing purposes. We will then explore some transfer pricing models that can be relevant for companies with related-party transactions competing in the telecom industry and discuss some considerations as to strengths and weaknesses of these transfer pricing models.

As we write this article AT&T has announced in a press release dated July 12, 2013 that it will acquire Leap Networks International Inc., subject to regulatory approval,

in order to expand its prepaid wireless business and improve its spectrum position.

The telecom value chain

There are historically three core components of the value chain for a telecom company – network infrastructure, network operations (including maintenance and installation), and customer-facing sales and related support activities (such as billings, collections, and installation). Although these core telecom production elements have existed in some form from the late 1800s to the present day, there have been dramatic changes in the value chain components and a significant expansion in the value chain brought about by technology evolution and associated regulatory changes.

Value chain: Preconvergence

It may be hard for many millennial wireless customers to imagine the environment in which telecom became available in the late 19th century compared to just 30 years ago. Telecommunications services were provided through copper wire by American Telegraph and Telephone (AT&T), the sole company providing telecommunications services in the US through its network, which was incumbent on local exchange carriers. Similarly, in most countries around the world there was a single telecom provider, typically a government entity. As the sole provider of telecom services, AT&T sought to maximise profits by creating cost efficiencies by vertically integrating the key components of its value chain. In particular, the AT&T family of companies included entities focused on research and development (Bell Labs), the manufacture of equipment at both the infrastructure level (copper wire, switches) and the customer level (outlets, telephones) (Western Electric Company), and those focused on operating the infrastructure and technology used to transmit the voice or data services and interfacing with customers directly to selling services and provide customer support (the regional Bell operating companies).

As a provider of what was a necessary public utility, AT&T was able to predict with relative certainty the number of customers, and by extension its customer revenue. Within this historical value chain there was a relatively low emphasis on addressing specific customer preferences (that is, providing differentiated products) because the customer had only one provider from which to purchase the services. For example, AT&T strictly enforced policies against using telephone equipment by other manufacturers on its network. Because AT&T did not need to differentiate its services and invest in acquiring customers, it was not necessary for them to develop marketing intangibles and invest in customer acquisition in the same way telecom providers do today. In this pre-convergence environment, the “customer link” in the value chain was not the key link for AT&T, and AT&T accordingly placed greater emphasis on driving profits through, for example, its

Bell Labs research and development activities and its Western Electric manufacturing activities (in addition to its significant product innovations, Western Electric was also a pioneer of Frederick Winslow Taylor’s scientific management methods, which lead to manufacturing and cost efficiencies.

). That is not to say that the customer was unimportant to AT&T, but in a market where the customer is captive and there is only one service provider the value of customer and marketing intangibles would be expected to be different than in a market where those circumstance do not prevail.

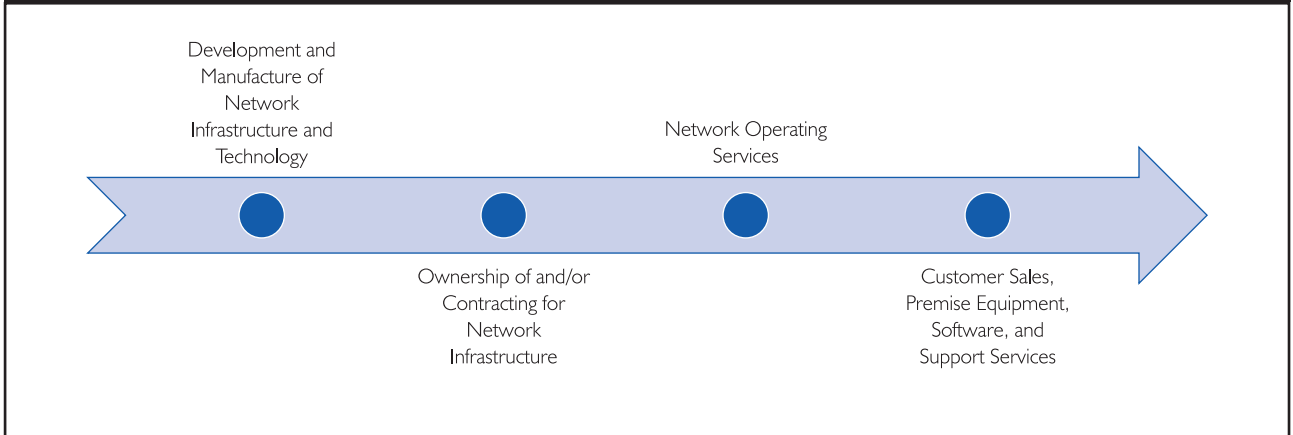
Deregulation and technological change: Convergence

While AT&T competitors did enter the industry in the 1950s to 1970s, competition among telecommunications service providers did not begin in earnest until 1984 with the Department of Justice decision to break up AT&T and the 1996 Telecommunications Act. Hand in hand with the new regulatory environment came the rapid evolution of telephony technology based on both wireless transmission and the ability to transmit both voice and data through internet protocol in data packets. The telecom technology evolution is perhaps better characterised as revolutionary, as analog voice transmission over fixed lines and a closed network led to the rise of wireless voice and data transmission over open networks, often using internet protocol. These infrastructure technological developments were increasingly performed by third-party manufacturers that were now outside the integrated telecommunications (“Telco”) services company value chain. And with increased competition to offer telecommunications and data services, the need to invest in marketing intangibles and acquire customers was much greater than in the preconvergence days of AT&T.

Convergence and the evolution of the value chain

With the rise of data services and the partial unbundling of infrastructure ownership from the provision of telecom services, along with the shift in the regulatory landscape (for example, the incumbent local exchange carriers were required to provide interconnects to competitive local exchange carriers and also offer unbundled services) the telecom industry became very competitive. As companies sought to retain or acquire customers and differentiate their service offerings, the nature and extent of intangible assets and risk profiles – both important considerations for transfer pricing – evolved. Access to the customer’s premises through either the existing Telco’s copper wire or the cable company’s coaxial cable, along with the existing customer relationship, became a key competitive factor (customer premises access is often referred to as “the last mile” or “the last kilometer”). With a customer relationship and an existing physical network the traditional integrated Telco companies competed head to head with the integrated cable companies to sell a bundled

Diagram 1



portfolio of services that included video and internet in addition to phone or voice services. As customers began to rely less on the fixed line for these data, video, and phone services, the integrated providers could also offer wireless services to their bundled service offering (for example, Verizon and Comcast cross-sell each other's bundled network and entertainment services). Of course, competing against the integrated service providers are companies that offer prepaid wireless, VoIP, or video as a stand-alone offering.

Competition has also evolved so that there is delineated market customer segmentation between residential and commercial services, in part to reflect the difference in customer requirements in infrastructure and services. Double – and triple –play bundled service packages to residential customers now commonly include home security services, and communications to customers and targets about data services often include the speed of the wireless or wired internet. Telecommunications services specific to commercial customers existed in the pre-convergence era (dedicated lines, multiple lines, for example), but the differences between residential and commercial services tended to be differences in scale rather than function (of course, there was often a difference in the nature of telecom equipment leased by commercial customers). Today commercial customers are commonly offered a suite of various IT services that may be bundled with data analytics services and remote hosting services in addition to the telephone, infrastructure, and/or other data services.

Before reviewing the transfer pricing components of the residential and commercial value chains, it is useful to take a step back for a big picture, generalised view of the telecom services value chain. At this generalised level, the key functions performed and assets employed in providing telecom services do not look markedly different for residential versus commercial services (see Diagram 1).

Unlike the pre-convergence period, today there are disaggregated service providers that may compete at only a single

link in the value chain. Also, infrastructure equipment development and manufacturing is no longer performed by the integrated telecom service providers. While integrated providers will almost certainly own significant infrastructure, it is also common for the integrated providers to contract with third parties for at least a portion of their network infrastructure footprint. Single-link market participants, such as prepaid wireless competitors, VoIP providers, and mobile virtual network operators may or may not own significant network infrastructure, and so may or may not face the economies of scale and the associated risks of utilising network capacity. However, the increased competition in the supply of telecom services has in some cases dramatically increased the fixed costs and risks associated with acquiring customers, leading to economies of scale benefits at the customer sales side of the value chain. The bundling of telecom services to both residential and commercial customers using double-play and triple-play pricing is one means of taking advantage of an existing customer relationship and to offset the customer acquisition costs to some degree.

Residential value chain – Integrated service providers

The incumbent cable service providers, already equipped with key links in the evolved telecommunications value chain – physical network assets, existing network technology, organisations to operate the networks and a strong customer base – as well as the resources to develop technologies specific to voice services, took advantage of the opportunity to enter into the market as integrated providers of telecommunications services. Through substantial capital investments in modifying physical networks and related technology to handle the provision of voice services, and through its efforts to deploy new and innovative services to existing video consumers, often through bundled service offerings, the entry of cable companies into this industry as integrated services providers and the estab-

lishment of these companies as core market participants has facilitated the development of a highly competitive market for residential telecommunications services. Just two decades after enactment of the Telecommunications Act, cable television providers now make up five of the top 10 residential phone companies in the country. And this is not unique to the US. On June 24, 2013 Vodafone announced that it was buying the German cable operator Kabel Deutschland for 7.7 billion euros, or \$10.1 billion.

The bundling of telecommunications services with video services was a successful method for motivating users of telecommunications services to switch from their historical telecommunications services provider as bundling reduced the transaction costs for procuring the portfolio of services. For example, customers could buy a double play or triple play bundle, paying a flat rate for all three services on one bill. In addition to attracting new customers, bundling is also a strategy for reducing customer turnover (churn) as it mitigates the risk of customers switching service providers. Essentially, the bundling approach attracts the customer and then creates “customer stickiness” once the customer begins to rely on the bundled services. The practice of attracting customers through bundling services was not new to the Telco industry, in which voice and data services had historically been sold together to customers, and Telco companies quickly launched their own video service offerings (AT&T U-verse, Verizon FiOS) to remain competitive. Some industry participants have questioned how significant video services may be for the integrated service providers in the long run. For example, the Wall Street Journal reported in its April 5, 2013 edition that James Dolan, Cablevision Systems Corp. CEO, stated in an interview “...that ‘there could come a day’ when Cablevision stops offering television service...”

The strategy of adding additional services to the bundle to potentially gain market share and further strengthen the customer relationship continues to be observed after the initial bundling of video with data and voice services. In the past few years, for example, integrated services providers have begun to offer a full spectrum of home management services (home security, remote management of lights, HVAC control, leak detection, etc.). More recently, as the population embraces mobile wireless devices, integrated service providers have also sought to include wireless voice and data services in the bundle. The trending use of mobile wireless technology is so marked that industry participants are investing more heavily to develop innovative new mobile technology service offerings that go beyond the capabilities of smartphones and tablets. AT&T, for example, announced in June 2013 that it is opening two new innovation centers, one focused on residential services and a second focused on commercial services, and will invest \$14 billion over the next three years to develop cutting edge wireless services.

Biography



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Experience

Dr. Peter Meenan is the Managing Principal in Deloitte Tax's Southeast Transfer Pricing practice and is Deloitte Tax's Transfer Pricing industry leader for the telecommunications industry. Dr. Meenan has 20 years of transfer pricing experience with Deloitte Tax. In addition to practicing transfer pricing in Deloitte Tax's Northeast and Southeast US regions, he has significant international transfer pricing experience. Dr. Meenan was on the European leadership committee and a founding member of Deloitte's European Transfer Pricing Practices during his seven year assignment with both Deloitte UK and Deloitte Germany. He also served as Deloitte's senior transfer pricing economist in Asia and co-leader of the Japanese transfer pricing practice during his four year assignment in Deloitte Tokyo.

Dr. Meenan has significant transfer pricing experience advising companies competing in the telecommunications, media, and technology industries in areas that include transfer pricing planning and implementation, audit defense, transfer pricing documentation, and advance pricing agreements and international arbitration procedures. He is a frequent speaker and an author on valuation and transfer pricing. Dr. Meenan developed Deloitte's pan-European and pan-Asian internal transfer pricing training courses while on assignment in these regions. Dr. Meenan has also been a consultant and a trainer for the tax authorities in the Czech Republic, Denmark, Malaysia, and Vietnam on transfer pricing matters.

Dr. Meenan received his Ph.D. in Economics from Purdue University and is a Chartered Financial Analyst. He has been voted on numerous occasions as a *World's Leading Tax Adviser* by International Tax Review and a *World's Leading Transfer Pricing Advisor* by Euromoney.

Residential value chain – Disaggregated service providers

The transition from a market dominated by a vertically integrated sole supplier to a competitive environment has created myriad opportunities for enterprises to enter into the Telco industry with a specialised focus on a single link within the value chain. For example, consumers can purchase digital media receivers (DMR) to access video content from the internet. And VoIP service providers such as Vonage and Skype provide service offerings focusing directly on customer facing interaction. These

Biography



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Experience

Ben Miller is a senior manager in the transfer pricing practice of Deloitte Tax. Ben has worked with numerous US domestic and multinational firms and foreign-based companies with US subsidiaries to evaluate the transfer prices of tangible goods, intangible property, financial services (e.g., loans and guarantees) and cost sharing transactions for various purposes, including 6662 penalty protection, planning, international supply chain restructuring, advance pricing agreements, preparation and implementation of audit defense, due diligence for mergers/acquisitions, and Section 199 purposes.

Ben earned his Ph.D. in economics from Georgia State University in 2008, with a focus in labour economics and public finance. Ben's research has been published in the *Industrial and Labor Relations Review*.

services are provided “over the top” of third-party infrastructure and therefore the core element of the value chain for a VoIP or DMR enterprise is to develop customer-facing technology and most importantly to attract customers, often by providing services at a lower cost than the integrated providers. Given that these over the top providers do not offer internet services in their bundle, they must engage in aggressive pricing and allocate a higher percentage of total costs toward marketing efforts relative to integrated providers to drive service revenue (VoIP providers have historically allocated 25% or more of their total budgeted costs to marketing efforts, whereas integrated providers have historically allocated less than 10% of budgeted costs toward marketing efforts). At the other end of the value chain, companies such as Level 3 and Qwest entered the market with the goal of developing the physical network. Developing infrastructure is extremely capital intensive and risky, with decisions regarding capital investments based on the anticipated use of such investments over the long term. Companies operating in this space are able to gain competitive advantage and drive profits by having a relatively cheap cost of capital and establishing an expansive footprint that enables customers to come to a single infrastructure provider to purchase access to infrastructure in geographically diverse locations or even globally. Other companies sought to focus on the develop-

ment of technology that enables the infrastructure, such as software and other classes of intangible property that optimise the use of physical network equipment. The focus of those companies is to attract and retain innovative and commercial professionals that can identify, develop, and commercialise technologies. As is the case with many research and development organisations, this type of enterprise will often incur development costs with little or no revenue while products or services are still under development.

Commercial value chain – Integrated service providers

In principle, the value chain for commercial telecommunications services in the converged environment is similar to the value chain for residential services described above (sending data packets from point A to point B through network infrastructure and technology, with services provided by a network operator and technology to interface the transferred data packets). That said, there are clear differences. For example, while both residential and commercial customers are interested in purchasing reliable, clear phone service, commercial customers may also seek service providers that can provide online voicemail and network security services, mobile network access, and integrate traditional voice-only services with Microsoft tools such as Outlook, SharePoint, and Messenger. Further, commercial customers generally consider reliability and speed of data services more important than residential customers, which has forced many service providers to upgrade their networks so they can provide faster and more reliable data service to commercial customers.

Companies within this segment of the Telco industry also seek to bundle products to attract customers and reduce churn; however, the bundle of services varies from what is offered commonly to residential customers. Commercial customers are more focused on purchasing telecommunications services from providers of fully integrated suppliers of IT solutions that bundle voice and data services with complementary services and customers are increasingly demanding that many of these services be provided through the cloud to reduce capital expenditures and shorten the timeline for receiving the services. Commercial customers also have a higher propensity to demand the latest technology, and integrated services providers must continuously innovate and develop new services to add to their bundle of services to successfully win and retain market share in the commercial services segment.

Commercial value chain – Disaggregated service providers

Similar to disaggregated residential services, the commercial segment of the Telco industry has seen the emergence of companies that specialise in providing services that target one link of the overall value chain. VoIP service providers that provide service offerings focusing directly on customer facing interaction are also common in the commercial services segment, with specialised bundled service offerings that incorporate the comple-

mentary services offered by integrated service providers described above. There is also a place for companies specialising in infrastructure services, network operations, and the development of software that optimises the use of the physical infrastructure and enables specific customer facing services (such as Cisco's WebEx webcast services offering that integrate voice, data and video services with a customer's incumbent IT systems). More specific to the commercial services segment, however, is the large number disaggregated service providers ranging from large established companies to startups that focus on the provision of cloud services, including software-as-a-service offerings, platform-as-a-service and infrastructure-as-a-service product offerings, as well as hosting companies specialising in remote hosting of webpages, storage of immense amounts of enterprise data, and performing analytics on such data. In many cases, these hosting companies provide services primarily through the cloud.

Transfer pricing and the telecom value chain

From the previous discussion it is easy to see that the nature and extent of tangible, intangible, and services transactions that are relevant to transfer pricing have evolved. In this section, we review transfer pricing models that are potentially relevant to telecom service transactions.

Finding the profit in telecom – risks and return to IP ownership

Compared to the pre-convergence period, the value of customer and marketing intangibles is generally higher, while technology development has predominantly migrated to third-party infrastructure manufacturers. In evaluating return to IP ownership, we will distinguish ownership of IP between legal ownership and economic ownership, since in many instances economic and legal ownership of property can be separated for transfer pricing purposes.

Economic ownership of IP is a subset of the property rights generally associated with legal ownership of intangibles. In transfer pricing, economic ownership of intangible property tends to be most relevant, because it is the economic owner of intangible property that has the right to receive the income associated with the intangibles. The determination of economic ownership for the right to receive income associated with valuable intangibles is fact-specific and depends on the following four key factors:

- Funding the development of the intangibles
- Bearing the risks of success or failure of the intangible development
- Performing the development functions and activities
- Employing the personnel that make key decisions regarding the intangible developments

While the importance of each of these four factors to the determination of economic ownership of intangibles is fact-specific, employing the personnel that make the significant decisions and bearing the risk of intangible development success and

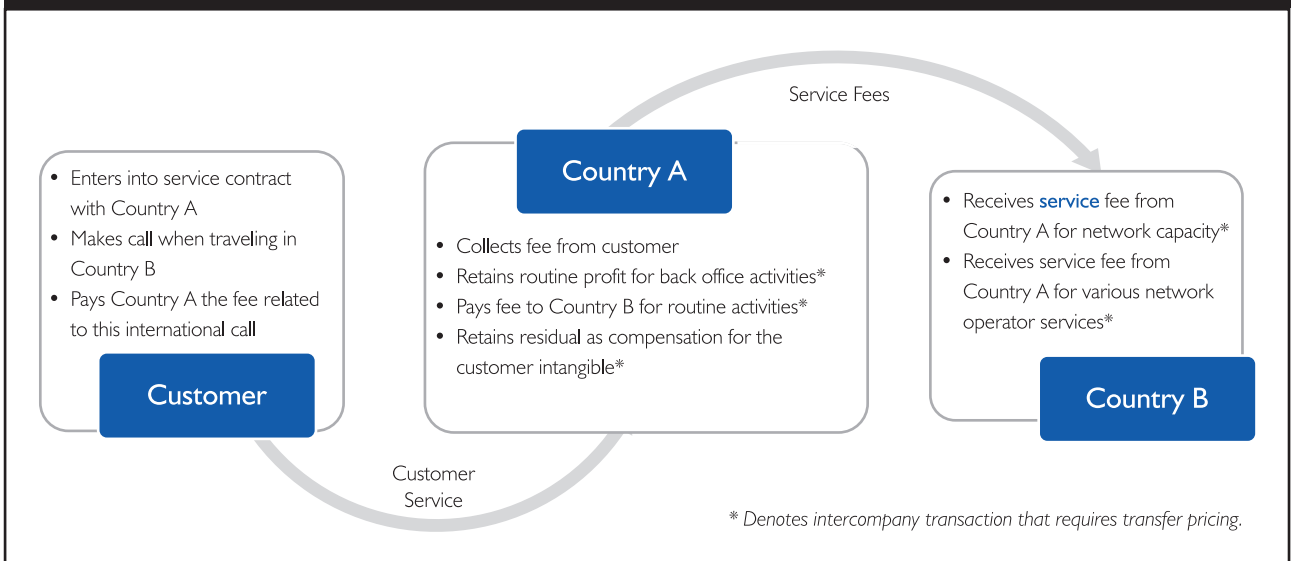
failure tend to be the most important determinants of economic ownership in many cases. So, for example, the legal entity that incurs the expenses and employs the relevant personnel responsible for acquiring customers for mobile virtual network operator or VoIP provider may be regarded as the economic owner of any marketing and customer list intangibles and so may need to be compensated by related parties that are using these intangibles to sell the services. This transfer pricing concept of economic ownership could also suggest that the customer and marketing intangible profit reward associated with bundled double play or triple-play product pricing or the sale of security or hosting services could rest with a legal entity that is not providing the security, hosting, or some of the –bundled services. That is, there could be a legal entity in the value chain that economically owns the customer and marketing intangibles apart from the legal entity providing, for example, home security or video services.

Another important concept in transfer pricing associated with arm's-length behavior is risk and the potential profit reward for bearing that risk, separate from the risk associated with the development of valuable intangible property. For example, infrastructure providers that own network infrastructure or telecom companies that commit to a fixed amount capacity usage have capacity risk associated with the utilisation of the physical network (For example, Indefeasible Rights of Use (IRUs) are common in telecom. An IRU is the right to use a fixed amount of communications capacity, or a certain communications facility, for a defined period of time). This capacity risk may be contractually borne by a legal entity other than the one that has the legal ownership rights of the physical assets or has committed to the capacity utilisation. Moving capacity utilisation risk means that relevant legal entities within the value chain are protected from losses or large movement in profits directly associated with network capacity utilisation, while the entity bearing the capacity risk may see its profit potential rise and fall as capacity utilisation rises or falls. For example, the entity bearing capacity utilisation risk could pay a guaranteed cost plus profit or a risk-adjusted return on assets level of profit to the entities that are protected from the capacity risk.

Transfer pricing models relevant to telecom

Much of the telecom value chain involves a network, most obviously the physical infrastructure network. Network models relevant to telecom reflect the fact that there may be multiple legal entities owning or utilising tangible, intangible, and capital assets and potentially collecting revenues that include the value of these tangible, intangible, and capital assets. Since the profit reward for intangibles, risk bearing, and value creation needs to be recognised at the legal entity regarded as the economic owner, risk bearer, and/or value creator, transfer pricing network models involve the planning or determination of pricing or profit flows such that the level of taxable income reported in an entity is consistent with its contributions in generating the relevant

Diagram 2



profits. The most common type of transfer pricing network model is called the profit split model.

Decentralised intangible ownership – Profit split model

A profit split transfer pricing model could be used to determine the split of the system profit when, for example, customer and marketing intangibles are used in a telecom service and are economically owned by more than one legal entity. Under a profit split model, a profit return and associated expenses for routine activities (billing/invoicing, installation and maintenance, the provision of infrastructure) is deducted from net revenue so that the remaining revenue is the residual revenue or gross profit associated with the intangibles employed to generate the system profit. This intangible residual revenue is then split between the intangibles owners based on factors that indicate the contribution of the intangible to the earning of the residual revenue or gross profit.

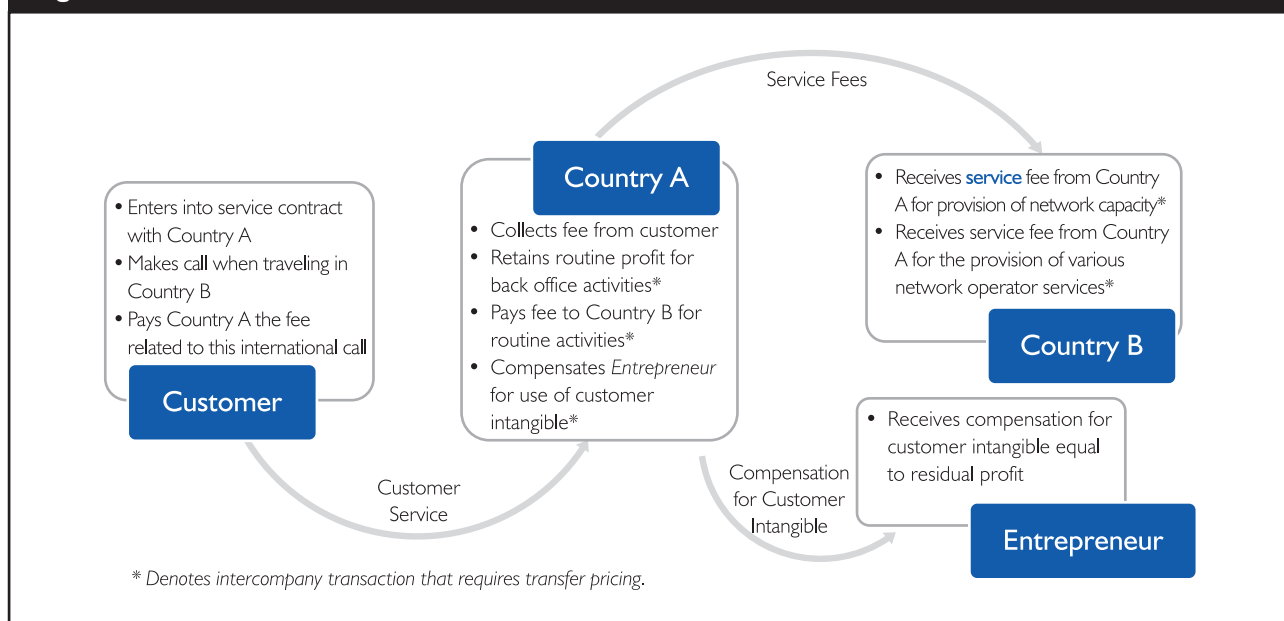
For example, consider a wireless virtual network operator that has an international footprint and provides its services in two countries, with customers that travel between the two countries. The legal entities in each of the two countries engage in local marketing activities to solicit, acquire, and retain customers, contract with third parties locally for network capacity, and perform the services necessary to operate the wireless virtual network. In this fact pattern, the purchase of network infrastructure and provision of network operator and back office services are activities that generate routine profit and the sales and marketing activities performed to attract and retain customers generate the intangible profit (As indicated before, there may be risks associated with a commitment to use contracted network capacity that potentially should be compensated as part of the routine profit.) Taking into account that the local

legal entities bore the expenses and associated risk to develop the customer base, the profit split method would suggest the above transfer pricing system for allocating the revenues/profits earned by the enterprise from a phone call made by an individual customer from Country A when traveling in Country B.

The transaction and financial flows are easy to see in the above model because the example involves one individual customer. But the full year financial statements for both the Country A entity and the Country B entity reflect commingled revenues and costs due to the fact that Country A customers travelled to Country B and utilised the infrastructure of the Country B legal entity, while Country B customers travelled to Country A and utilised the infrastructure of the Country A entity. The profit split would proceed by measuring the combined system revenues and costs of both the Country A and Country B legal entities, rewarding their routine activities by reimbursing their costs plus the appropriate routine profits and splitting the revenue remaining after deducting these routine reimbursements based on the relative value of the customers that they contribute to the business. In this simple example we assume that the pricing to customers and intangible development costs and risks in both Country A and Country B are the same and the relative value of the customers in generating intangible profit is equivalent in both countries.

While the example above is simplistic, in practice a profit split model involving multiple legal entity ownership of valuable intangibles is a relatively sophisticated and complex transfer pricing system. For example, the determination of arm's-length transfer prices for each of the intercompany transactions identified in Diagram 2 with an asterisk could involve a degree of complexity. One approach to simplifying the transfer pricing system is to concentrate the intangible property ownership and

Diagram 3



potentially some risks in a hub or entrepreneurial company through a model that is often referred to as a hub-and-spoke transfer pricing system.

Centralised intangible ownership – Hub-and-spoke model

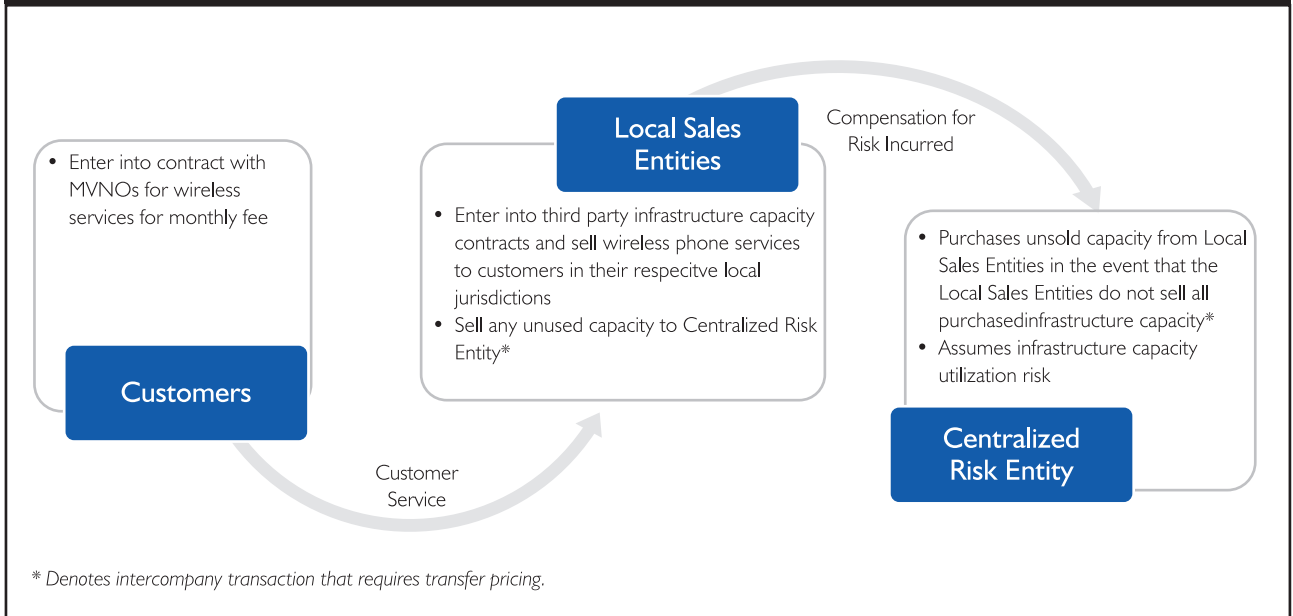
In some cases, providers of telecommunications services choose to centralise the development of core intangible property for reasons such as achieving economies of scale, optimising resource allocation, and managing risk. In this type of hub-and-spoke business model, the legal entity developing the core intangible property regarded as the economic owner of the resulting intangible property incurs all development costs, has employees making the significant intangible development decisions, and incurs the associated risks in creating the intangible property. This entrepreneurial entity will then provide the developed intangible property to its related parties for use in their local markets, in return for compensation reflecting the arm's-length nature of the value in the local market of the intangible property provided.

For example, one area in which sellers of telecom services may seek to centralise their efforts is in the development of global marketing strategies, including the funding of the creation and design of advertising and promotional campaigns as well as the development of pricing tools and other relevant software for use by the local entities. Using the example introduced above, we now assume the local entities in Country A and Country B perform only routine sales and marketing activities to execute the marketing strategy established by a new entity we introduce called the "Entrepreneur". The Entrepreneur performs the functions

and bears the risks associated with the global marketing strategies, whereas the Country A and Country B local entities perform routine marketing execution activities such as distribution of marketing materials to customers, placement of advertisements in media outlets, etc. The Entrepreneur is the economic owner of the profits associated with the marketing intangibles and so would need to be compensated out of the revenues embodying these intangibles collected by the Country A and Country B local entities. Again viewing the transaction flows from an individual customer perspective, the legal entity in Country A would need to pay the Entrepreneur for its use of the Entrepreneur's marketing intangibles, which are embedded in the revenue that the Country A legal entity collects from the Country A customer, regardless of whether the customer makes a call in Country A or Country B.

The full year revenues in the financial statements for both the Country A entity and the Country B entity would reflect the value of the use of and revenue benefit from the Entrepreneur's marketing intangibles. Thus, the legal entities in Country A and Country B would need to pay Entrepreneur the arm's-length amount of the local value of the Entrepreneur's marketing intangibles. In this simple model, Country A and Country B receive the costs and profit reimbursements reflecting the routine nature of their value chain contributions, while the complete residual revenue or profit is paid to the Entrepreneur. The arm's-length transfer prices required for this example of the hub-and-spoke model on an individual customer transaction level is identified in Diagram 3 with an asterisk; in general, a transfer pricing system

Diagram 4



designed under the hub-and-spoke concept is easier to administer than a profit split model.

Concentrating risk bearing through transfer pricing

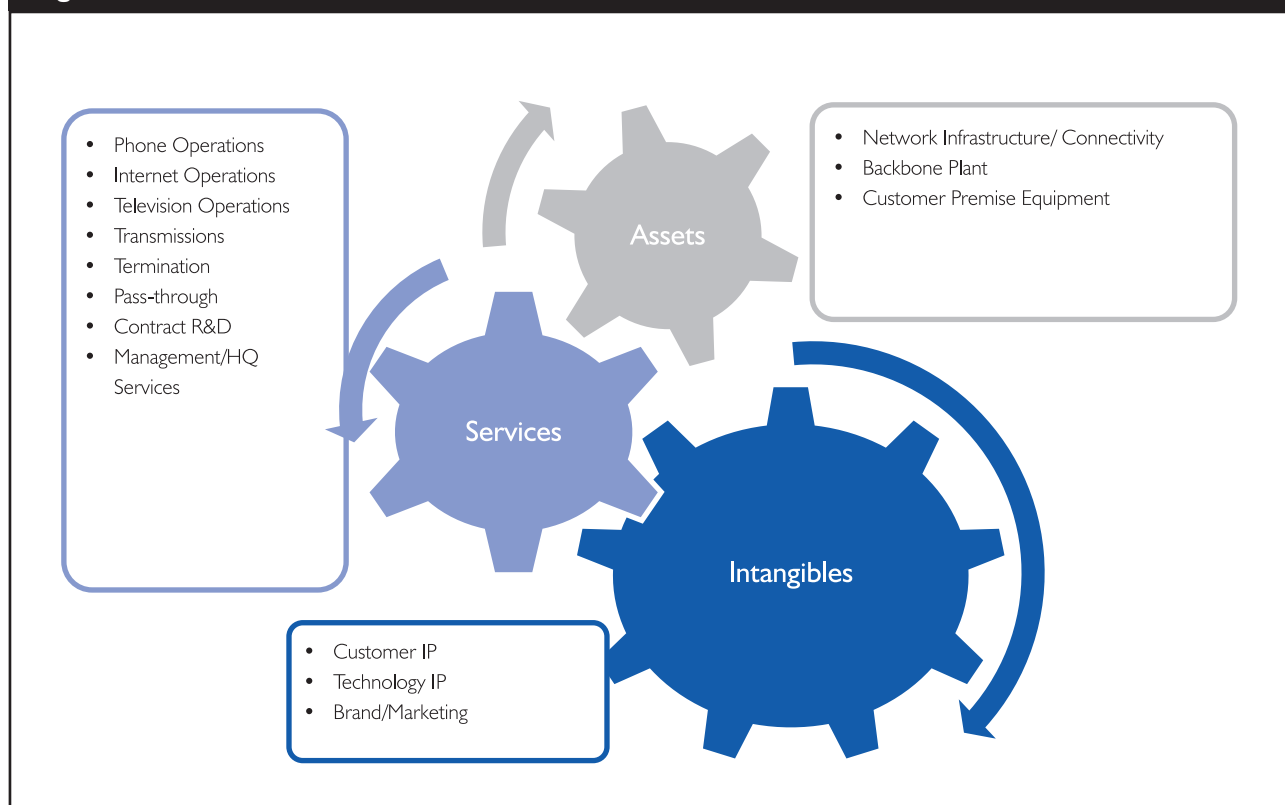
Although overall business risks cannot be mitigated through transfer pricing, the concentration of certain risks within one legal entity can often be accomplished through transfer pricing planning. Concentrating risks within a legal entity potentially has many benefits, including simplifying a transfer pricing system, determining that potential tax losses associated with negative risk events is not dispersed over legal entities in many countries, and improving the expected taxable income in a legal entity that bears the risk. For example, a mobile virtual network operator providing wireless telecom services in several countries where the legal entity in the country locally contracts for network capacity from third-party infrastructure capacity providers. To the extent the infrastructure capacity contracts require the mobile virtual network operator to commit to the use of a specified amount of infrastructure capacity, the mobile virtual network operator faces infrastructure capacity utilisation risk in each of its local legal entities where such contracts are concluded. To concentrate this capacity utilisation risk in one entity, the risk-bearing entity can provide a guarantee to the other local entities entering into infrastructure capacity contracts against bearing expenses associated with underutilised network capacity. The risk-bearing entity would need to receive a profit risk premium for bearing the infrastructure capacity utilisation risk (see Diagram 4).

For integrated service providers and disaggregated services providers alike, the strategy to concentrate risk in a particular entity may provide opportunities to concentrate functions or assets as well. For example, the risk-bearing entity could also perform central negotiations of all infrastructure contracts and potentially take advantage of the pricing benefits that may be associated with scale purchases of infrastructure capacity or other products or services. In general, by separating the financial risks and key strategic decision-making roles from the roles involved in executing the established strategy, an enterprise can isolate and enjoy benefits from locating the economic ownership of a given class of intangible property in an entity other than that which performs the majority of the development activities.

Identifying the intangible versus routine contributions in a bundled pricing model

As discussed in detail above, telecom services providers regularly bundle their telecom voice services with other complementary services to attract customers and reduce customer churn. On the residential customer side, triple-play pricing may include combinations of internet, video, fixed line phone, home security, or wireless phone. On the commercial side phone, data, IT services, and internet infrastructure are commonly offered as combined pricing. The offered services that are priced in combination within the bundle are not equally valuable from a transfer pricing value chain perspective, which introduces the possibility to use transfer pricing to determine the contributions by the legal entities providing the components of the bundled services. For example, some

Diagram 5



legal entities within the value chain may perform routine activities in support of the provision of the bundled service offering, while other legal entities may contribute valuable intangible property. Transfer pricing principles are relevant to determining the pricing or profit reward that is attributable to the value chain components contributed by entities providing services with the bundled pricing packages.

Diagram 5 outlines at a high level the types of services, assets, and intangibles common to telecom services providers providing a product bundle that includes phone, internet, video, and home security services.

As suggested by the graph above, crucial to the design of a transfer pricing model that involves bundled pricing of services is the ability to identify the core intangible property that drives the revenues associated with the offers of bundled services; for some companies, it is the existing customer relationships that drive the offer of bundled services. As is the case in other transfer pricing models, key intangibles utilised to sell services to customers are not always economically owned by the legal entity providing the customer facing telecom services and booking the cus-

tomers revenue. Transfer pricing principles under the arm's-length standard provide a very effective approach to determine the value of the contributions by related parties within the value chain.

Potential change

The convergence of the telecom services value chain with the associated bundling of telecom services to customers has potentially changed the nature and value of related-party transactions involving services, intangibles, and tangibles property. These shifting transactions and continued convergence have also impacted at least some business risks of related parties competing along the value chain. Specifically, the value of customer and marketing intangibles have increased for some market participants as the ability to offer double and triple play bundled pricing creates customer stickiness and potentially enhances the scale benefits associated with the high fixed costs of telecom infrastructure. There are various transfer pricing models that can help taxpayers deal with the continued convergence in telecom to address the specific facts and circumstances of the business.

Transfer pricing controversies in the TMT sector in India

Skilled yet relatively low-cost manpower, the low cost of production, and a growing customer base are the key factors that have attracted multinational enterprises (MNEs) to India. **Rahul Tomar** and **Kulvinder Makkar** focus on the emerging transfer pricing issues and their influence on the companies in technology, media, and telecommunications (TMT) industry in India.

Technology

Over the years, India has gained a special position and made significant advances in the technology sector, with the advantages of a strong labour supply and growing demand. Businesses are investing increasingly in new technologies to stay competitive and provide innovative value propositions to customers.

The first thing that comes to mind when India and technology are mentioned together are the vast software service centres located in India. According to a report jointly prepared by the Boston Consulting Group and the Confederation of Indian Industry: "The Indian IT Industry has been a key driver in the new knowledge economy and [is] expected to touch \$100 billion in fiscal year 2013, approximately 7.5% of GDP." The information technology/information technology enabled services (IT/ITeS) sectors in India lead the economic growth in terms of employment, export promotion, revenue generation, and standards of living. The market size of the IT/ITeS industry is expected to rise to \$225 billion by 2020.

On the demand side, technology adoption in India has not been the same across industries. Certain industries such as banking, insurance, and telecom have embraced technology to efficiently carry out revenue-generating functions, back-end support functions, customer interface, and billing functions. Conversely, technology penetration has not been significant in other sectors, including healthcare, education, government, and retail.

Media

The media industry in India is multidimensional, and predominantly follows the global trends of digitisation and convergence. India has been a developer of content and media technology, while becoming a growing consumer of global content.

The media and entertainment industry in India grew at approximately a 12.6% rate in 2012, and is expected to grow at an 11.8% rate in 2013, driven by digitisation and growth in new media. In spite of being the most prolific movie making country in the world, television production dominates the media and entertainment landscape in India, growing at a 12.5% rate in 2012 and accounting for \$6.37 billion of total revenue in this industry. Films were ranked third behind the print industry in terms of revenue, accounting for \$1.9 billion.

In terms of content development, animation is an emerging industry. The current size of the Indian animation industry is estimated at \$247 million, and it is expected to grow at a rate of 15% to 20% per annum. The Indian animation industry employs over 80,000 people, and there are over 650 animation studios in India located in cities such as Mumbai, Hyderabad, Chennai, and Bangalore.

Telecommunications

The telecommunications sector in India has been one of the fastest growing industries since the last decade, and it is likely to continue to be on a growth path in the coming years. According to a report prepared by Telecom Regulatory Authority of India, the total wireless subscriber base in India through January 2013 was 863 million, of which 708 million (approximately 82%) were active mobile users. While the mobile subscriber base is growing exponentially, the number of landline users in the country is gradually decreasing.

TMT sector – Growing tax controversies

Taxpayers in the TMT sector inherently have high intellectual property content, and the time gap between investment and returns can be long, subjecting companies in these industries to fluctuating returns. Moreover, in India, this industry continues to evolve, leading to more unpredictable returns. For instance, one major player within the telecoms industry – Reliance Communication Limited – was barely able to break even last year, whereas another major company – Bharti Hexacom – earned an operating margin of approximately 30%. As a result, this industry has been increasingly under the lens of the Indian tax authorities from a transfer pricing perspective.

The TMT sector has been facing audits on various issues, most of which relate to basic transfer pricing analysis such as the type of comparable companies selected, use of single-year data, and application of a turnover filter. For instance, in the recent case *Vodafone India Services Private Limited* (Vodafone India), the Mumbai bench of the Income Tax Appellate Tribunal (ITAT) disagreed that Vodafone India was providing low-end activities, and allowed the selection of companies providing high-end services to be used as comparable. ITAT further held that arguments such as high turnover and super normal profits were not sufficient basis to consider a company as not comparable. In a contrasting decision, the Bangalore bench of ITAT ruled in favor of *Autodesk India Private Limited*, which is engaged in rendering technical services for the development of entertainment products including 3D animation, and accepted the taxpayer's argument for exclusion of companies with significantly high turnovers.

Factors relating to turnover filter and super normal profits are significant because rather than relying on the interquartile range, which excludes outliers, the arithmetic mean of comparable companies' return is used to calculate the arm's-length price.

Other recent issues affecting the TMT industry include the treatment of research and development (R&D) centres, marketing intangibles, location savings, and intragroup services.

Captive R&D centres

Generally, MNEs maintain that the Indian affiliate is a captive R&D centre, involved in less complex functions and bearing

insignificant risks in the overall value chain, however, the tax officers have argued that these entities perform significant functions, and therefore should be considered to bear significant risks. This notion has been the subject of litigation, was outlined in India's submission to the United Nations *Transfer Pricing Manual for Developing Countries*, and was reinforced in a recent circular released by the Indian government. For instance, in the case of *GE India Technology Centre Private Limited*, the ITAT emphasised that an R&D centre cannot be completely risk free, if core R&D activities are carried out in India.

Because of the increasing number of audit controversies, the Indian tax authorities recently released a circular to provide clarification on the issue of R&D centres. The circular lays down guidelines to identify a contract R&D service provider assuming insignificant risk. The circular requires that the foreign principal perform economically significant functions, provide capital and other economically significant assets (including intangibles), provide direct supervision, assume economically significant realised risks, and have ownership rights (legal or economic) on the outcome of the research, for the Indian R&D centre to be classified as a contract R&D service provider.

Marketing intangibles

In the last few years, a highly debated issue in transfer pricing audits and litigation has been the existence of marketing intangibles, when the Indian affiliates of MNE groups incur significant advertising, marketing, and promotion (AMP) expenses.

In the case of *LG Electronics India Private Limited*, the special bench of ITAT in its detailed order held that incurring AMP expenses by the taxpayer toward building a brand legally owned by the foreign affiliate constituted a "transaction" and the foreign entity should pay for the AMP expenses above the bright line. Bright Line test was laid down by the US Tax Court in the case of *DHL Incorporated*, wherein it was held that the expenditure on advertisement and brand promotion expenses which exceeded the average of AMP expenses incurred by the comparable companies, created marketing IP. *Haier Telecom Private Limited*, from the telecom industry, and *Star India Private Limited*, a prominent media company in India, were also part of this litigation as interveners. The ITAT's decision will have far reaching effect and will impact a large number of Indian taxpayers that are incurring significant AMP expenditures in respect of global brands in India.

In our view, the issue is far from being resolved, and more litigation is expected.

Location savings and location specific advantages

The tax authorities have argued that due to easy access to low-cost skilled manpower, MNEs enjoy substantial cost savings in India. In addition to location savings, MNEs also obtain

Biography



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Experience

Rahul is currently a senior director of transfer pricing in Deloitte's Delhi office. He led the Philadelphia transfer pricing group of Deloitte US before moving to India in October 2012.

He has more than 11 years of experience in transfer pricing, mostly in the US, and for another four years he has been involved in valuation, pricing analysis, and negotiation work.

Rahul has managed and led transfer pricing engagements involving planning, documentation, and controversy work, across more than a dozen industries, including healthcare, industrial products, technology and telecom. His specialisation is in assisting clients with transfer pricing planning, often covering complex transfer pricing structures involving intellectual property analysis, restructuring, and entity conversions. Rahul has also led global documentation projects coordinating with Deloitte colleagues in over a dozen countries.

He has co-authored a number of transfer pricing related articles published in international trade journals such as the Transfer Pricing Report and the International Transfer Pricing Journal, and has spoken in a number of seminars and forums.

Education

- M.B.A. from the Wharton School;
 - PGDM from IIM Bangalore; and
 - Bachelor of Technology from IIT Kanpur.
- Rahul is also a CFA charter holder.

certain location-specific advantages, such as access and proximity to growing local/regional markets, superior information and distribution networks, and a large customer base with spending ability. However, thus far, there has not been a successful effort to quantify the impact of location-specific advantages.

Royalty payments

Payments of royalties for brand names, trade-marks, and technical know-how by the Indian affiliate to the overseas

Biography



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Experience

Kulvinder Makkar is a senior manager with the transfer pricing practice of Deloitte Haskins & Sells and is based out of the New Delhi office. Kulvinder has over 10 years of experience in transfer pricing.

Kulvinder has served transfer pricing clients of Deloitte and another Big 4 accounting firm in Canada and has worked as an in-house transfer pricing expert with the 3rd largest insurance company and the largest bank in Canada in their capital markets division.

His experience includes specialisation in conducting transfer pricing studies and documentation for clients, expertise in representations at the tax office for TP audits, expertise in preparing and filing TP appeals with the appellate authorities and experience in reviewing and planning international agreements.

Kulvinder has been a regular speaker at various industry and professional associations on topics relating to domestic and international transfer pricing subject.

Qualification and Professional Affiliations

- Bachelor of Commerce
- PG Diploma in Business Management
- Chartered Accountant – ICAI, India
- Certified Public Accountant – AICPA, USA

MNE are often challenged by the Indian tax authorities. It is important to note that until a few years ago, India's Central Bank (the Reserve Bank of India) imposed a cap on the amount of royalties that could be paid out of India. After this cap was removed, the amount of royalties paid out has crept up, and often caused suspicion in the minds of Indian tax officers.

In the case of *Samsung India Electronics Private Limited*, the tax officer challenged the payment of royalties to Samsung Korea for technical know-how on sales made to the MNE group, arguing that those sales tantamount to sales to itself. The Delhi ITAT held that sales made to another company within the MNE group do not amount to sales to itself,

and the tax officer had wrongly endeavored to reach the so-called economic substance, ignoring the legal substance accepted and admitted in separate jurisdictions. The tax officer also contended that the taxpayer had not demonstrated the benefit derived from the payment of such a royalty. Although ITAT in this case compared the royalty payment with third-party royalty payments and considered it at arm's length, there are a number of other cases in which the importance of the "benefit test" has been emphasised.

Passing the benefit test in connection with allowing the payment of royalties has been discussed and upheld by the appellate authorities. The benefit test evaluates the transaction according to the following parameters:

- Do taxpayers require such intangible assets?
- Have the intangible assets actually been received?
- Has the use of intangible assets resulted in any benefit?
- Has appropriate documentation been maintained to demonstrate the receipt of intangible and direct or indirect benefit derived therefrom?

Passing the benefit test will be an important factor in scrutinising royalty payments in the future.

Intragroup services

The Indian transfer pricing regulations do not specify the manner in which an arm's length price must be determined for payment for intragroup services. The key to determine the price is whether the services have actually been provided and whether the benefit test has been met.

In a recent case, *McCann Erickson India Private Limited* paid management service fees and coordination costs, and applied the transactional net margin method (TNMM) to substantiate the arm's length price. The tax officer rejected

the TNMM and contended that the taxpayer had failed to demonstrate the benefit derived from such services. The Delhi ITAT upheld the application of TNMM, because the various businesses were interrelated and constituted a single business. Regarding benefit derived, the ITAT held that the benefit derived and occurring to the company must be considered from the angle of a prudent businessman. The term "benefit" to a company in relation to its business has a very wide connotation. It is difficult to accurately measure these benefits in terms of monetary value.

Similar issues were discussed and decided in a number of other cases, which held that payments for intragroup services must satisfy the key attributes similar to the benefit test discussed above.

Transfer pricing policy

For sustainable growth in the TMT industry, it is critical that companies operating in multiple jurisdictions have a well laid out transfer pricing policy, and that intragroup transactions satisfy the arm's-length standard supported by robust documentation.

Tax authorities have introduced an advance pricing agreement regime in India effective July 1, 2012, which is likely to provide reasonable certainty to taxpayers in connection with transfer pricing matters. On the other hand, domestic transactions have been brought into the ambit of Indian transfer pricing regulations with effect from April 01, 2012, which reaffirm the Indian tax authorities' aggressive stance. Therefore, both MNE group and Indian TMT companies must be well-prepared, from the initial transfer pricing planning to maintaining comprehensive documentation, and implementing a robust strategy for transfer pricing audits.

Would LSAs affect technology companies in China?

Originally, whenever people talked about location savings, they thought about those manufacturers that produced goods with lower than average costs to keep their competitive edge. Eunice Kuo and Nick Chen of Deloitte China explain that technology companies may need to keep an eye on this issue if costs in different operating jurisdictions allow their businesses to become more competitive.

Technology companies operating in China must consider how location-specific advantages may impact their global transfer pricing. Although not a new risk, recent developments have put renewed focus on this controversial topic – one that technology companies should address.

The renewed focus was clear in October 2012 when China released its contribution to the UN Transfer Pricing practice manual, in which location-specific advantages (LSAs) took a prominent place. That same month, China and the United States concluded a bilateral advanced pricing arrangement (BAPA) for a U.S. technology company. Under that agreement, the Chinese subsidiary was remunerated for location-specific advantages, and the agreement recognised local enhancements to the group's intellectual property (IP).

Now the tax authorities in China are increasingly claiming that Chinese subsidiaries should earn excess profits, or at least share part of the group's residual profit because of the group's operating profits from low-cost labor, tax incentives, financial subsidies, market price premiums, and low cost related factors linked to the Chinese economy. For technology companies, the stakes can be high.

What are LSAs?

LSAs have been briefly addressed in the OECD transfer pricing guidelines for many years. Location savings were the focus of the business restructurings section (Chapter IX), which stated:

"Location savings can be derived by an MNE group that relocates some of its activities to a place where costs (such as labor costs, real estate costs, etc.) are lower than in the location where the activities were initially performed, account being taken of the possible costs involved in the relocation."

References to LSAs have also appeared repeatedly in China's tax rulings and practices. Despite this, a precise definition had not been issued until the release of Chapter 10.2 of the UN Transfer Pricing Manual in October 2012, which stated:

"The globalization of trade and economies has given rise to concepts such as "location savings," "market premium," and more generally, location-specific advantages. The LSAs are advantages for production arising from assets, resource endowments, government industry policies and incentives, etc., which exist in specific localities."

The Chinese tax authorities are now keen to put the LSA concept into practice. Practitioners have already seen this concept being raised in current advanced pricing agreement (APA) and transfer pricing audit cases. The LSA arguments are raised for both market premiums and location savings.

Market premiums

Market premium is a term used for surplus profits attributed to higher local prices or high demand leading to increased prices, caused by differences in market conditions. China's State Administration of Taxation (SAT) claims a premium exists in the Chinese market for some products because of:

- Consumer preferences for foreign brands and imported products, such as luxury goods; or
- China's large population with growing wealth.

The market premium concept is sometimes linked with China market intangibles created by successful local marketing efforts. Based on these concepts, the Chinese tax authorities may discount the contributions of foreign intangibles and conclude that domestic Chinese marketing IP exists.

Location savings

The SAT approaches location savings by considering the cost savings of companies that relocate operations to China on a net basis. This approach considers inputs such as raw materials, labor, rent, transportation, and infrastructure, and additional expenses such as increased training costs, relocation costs or tariffs. However, it is unclear how the SAT will deal with other aspects of location savings, such as when all or part of the cost savings effect has been passed to customers.

In the past, the SAT has dealt with under-remunerated Chinese affiliates by demanding the application of higher transfer pricing mark-ups to low-margin or contract providers that benefit from location savings. This position is now evolving to adopt a more robust approach of calculating and attributing the location savings.

Quantification of LSAs

The Chinese tax authorities have consistently stated that Chinese taxpayers have to be remunerated for their LSAs, however the calculation of the benefit has been traditionally controversial.

The SAT has suggested a four-step approach to quantify the LSAs described above in the UN Transfer Pricing Manual, although there is no specific regulation on how to identify and quantify LSAs in China. The four steps are explained as follows:

Identify if an LSA exists

The first step is to identify whether an LSA exists by evaluating incentives or market characteristics that could have an effect on profitability – industry analyses and company's profitability analyses can be critical at this stage. Each characteristic should be individually reviewed. If no LSAs are identified, no further analysis is required.

Determine whether the LSA generates additional profits

The next step is to perform a cost base/price comparison between China and the appropriate benchmark jurisdiction.

This stage may require some professional judgment, as the factors to consider are not defined, for example, should you consider whether the cost savings effect is passed to end customers?

Quantify and measure the additional profits arising from the LSA

Multiple factors could contribute to additional profits in China. The taxpayer should identify costs that materially offset any additional profits, such as relocation costs and other dis-savings. The net value after the offset would be the additional profits that resulted from the LSA.

Determine the transfer pricing method to allocate the profits arising from the LSA

According to the OECD transfer pricing guidelines, location savings should be allocated in the same way that independent parties would split them. This would depend on the functions, assets and risks of each party and on their respective bargaining powers. Unfortunately, splitting the profit could not possibly be this simple in practice – each tax authority will likely surely have a different view.

How would LSAs affect technology companies in China?

Certain technology companies have benefitted from the globalising economy by establishing operations in China to take advantage of lower manufacturing costs, well-educated staff in research and development (R&D) centres, and a rapidly emerging consumer class. These operations are typically limited-function operations (contract or toll manufacturers, contract R&D providers, or limited-risk distributors). These companies retain relatively small profits in China, while sometimes contributing significantly to group profits. Technology companies need to consider how LSAs could impact their own China subsidiaries before the SAT.

Contract R&D services

In today's highly competitive market, some technology groups are establishing R&D centres in China to help target Chinese consumers, and benefit from highly educated Chinese employees. These types of R&D services are used by the SAT as an example to demonstrate how to identify LSAs and allocate the excess profit to Chinese entities – a position challenged by taxpayers and advisors.

Technology groups often set up R&D centres in China that perform work at the direction of the global technology centre – the global technology centre will own any results. The contract R&D centre in China is paid for services based on its costs plus an arm's-length mark-up for R&D service providers.

To quantify the location savings effect, the following two methods of calculating the LSA are explored used:

Direct approach

A direct approach simply compares the direct costs of doing business in one country, with those of another country – easy in principle, hard in practice. There should always be an argument about whether the developed country's cost should be used directly as the benchmark for comparing costs. Rather, there is a better view that the next best jurisdiction's cost would be a better benchmark to use.

Steps	Description
Step 1	Compare each cost item for the benchmark country and the China company and then identify all the factors contributing to LSAs
Step 2	Quantify the net savings for each factor (savings and dis-savings)

This approach has a major drawback as many factors cannot be specifically identified or directly quantified. For example, although salary differences may be obvious, the difference in education and skill levels between groups of employees cannot be practically quantified accurately. Furthermore, lower costs may impact the scale of the R&D and the selling price to customers.

Indirect approach

The indirect approach depends on a comparable uncontrolled price/transaction, or otherwise suitable benchmark to determine the routine profits of the Chinese R&D centre and a way to attribute the residual profit of the group to the Chinese R&D centre. If any crucial IP would be generated in the covered transactions, the reasonable economic return on the IP will be excluded prior to attributing the residual profit to LSA's contributor.

This table outlines the possible way to allocate LSAs to China using the indirect method.

Steps	Description
Step 1	Calculate routine profits of the Chinese R&D center and related party
Step 2	Identify allocation key to residual profit
Step 3	Allocate part of residual profit to China based on identified allocation key
Step 4	Determine the adjusted arm's length return for China

If there is no internal comparable, Chinese or regional comparable service providers may have to be used. However, comparable companies with their main operations in developed countries (such as Japan) may be challenged as not comparable. While comparable profit methods (CPM or TNMM) would be extensively used, the residual profit split

Biography



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Nick Chen is a Manager in the transfer pricing service line of Deloitte China.

Experience

- Nick has 8 years' experience in providing professional service. Before entering Deloitte China, he served in the audit department of Deloitte Taiwan and engaged in financial statement audit, examination of income tax return and review of transfer pricing report for subsidiaries of multi-national enterprise;
- Nick renders transfer pricing services, such as preparation of transfer pricing reports, planning for cross-border transfer pricing risks on the association between enterprises, assisting enterprises to negotiate transfer pricing agreements and tax adjustments;
- Nick Chen has been serving many multi-national companies of technology, media and telecommunications sector for many years in the aspects of cross-border tax issues and transfer pricing matters.

Professional Accreditation and Certifications

- Nick is a Master of Accountancy and Finance of University of Glasgow.

method may be preferred by the SAT for contract R&D services.

Either approach raises many issues. It is debatable whether all the location savings would be retained by the group. In fact, local R&D centres are not usually set up for location savings, but for company strategy and other business reasons, such as proximity to production sites to lower production costs and market, etcetera. Therefore, an analysis showing the product's price trends or the profitability of the group may be important to demonstrate that other factors (other than location savings) exist. Decrease in product prices or the group's overall sales or profitability could demonstrate that location savings have been passed onto consumers.

Furthermore, the argument for location savings asserted by the tax authority may not be sustainable in the long run. As more competitors enter into China, the savings from the location will decline as the savings are passed to customers through competition. However, this doesn't mean the SAT will not continue to raise the issues.

Contract or toll manufacturing in technology sector

As with contract R&D activities, many technology companies have shifted their factories or manufacturing operations to developing countries. The savings from manufacturing activities are often much larger than those for services, and are much more complicated to deal with as cost savings may be passed onto consumers.

Taking the electronic manufacturing services (EMS) sector as an example – Chinese affiliates comprise the bulk of manufacturing and assembly activities. These activities usually require large workforces, vast plants, and high expenditure on capital equipment in China. The cost savings from these inputs could be very significant. As these manufacturing operations are generally contract or toll manufacturers with low risk profiles, they are prime candidates for a review. If LSAs are identified and quantified, the allocation would require analysis of the functions, assets and risks of each party; their respective bargaining powers; the beneficial ownership of intangibles; and contractual rights to distribute products directly to third party customers.

However, these Chinese affiliates usually purchase key components from and can only sell the products to overseas related parties, and should never have R&D responsibilities. Therefore, it could be difficult to conclude that the Chinese manufacturers have any bargaining power – although clearly they are considered important to the group, complicating any allocation of the benefits.

Distribution of technology products

Most Chinese consumers have a strong preference for foreign brands and imported products. This is a general preference, unlike loyalty to a specific brand. The SAT concludes that this preference creates opportunities for brand-centric technology companies to charge higher prices and earn additional profits on products sold in China. Although China market premiums are more commonly expected in the luxury goods sector, the concept is being applied broadly. An analysis of market premiums will need to take account of differences in indirect taxes (such as tariffs, value added tax, and anti-dumping duties) and other China market factors. There is also a danger that a review of market premiums may raise questions about the marketing contribution made by the Chinese distributor or retailer. Adding marketing intangible claims to market premiums would certainly complicate the calculation of sales side LSAs.

Controversy

Location-specific advantages are still a highly controversial topic in emerging markets. Given their actions so far, it appears that the Chinese tax authorities will apply the concept in tax controversy cases. Affected technology companies should review their policies, consider responses to

Biography



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Eunice Kuo, a tax partner of Deloitte China, is the national leader for China/Hong Kong transfer pricing service in charge of transfer pricing, business model optimisation, and tax-structuring services.

Experience

- Ms. Kuo has 27 years of experience in providing cross-border tax service. Before joining Deloitte China in 2010, she was the tax practice leader and led transfer pricing and international tax services of Deloitte Taiwan.
- Ms. Kuo has many years of providing transfer pricing services. She started up Deloitte Taiwan's transfer pricing practice. She has worked with the preparation of transfer pricing reports, planning for cross-border transactions including supply chain issues, performing transfer pricing due diligence at mergers and acquisition projects and helping mitigate transfer pricing risk, assisting in settling tax audit cases, helping with conclusion of advance pricing agreements and mutual agreement procedures, and advising on tax issues from business restructure.
- Ms. Kuo is experienced in serving multinational companies' inbound activities as well as China- and Taiwan-based multinational companies' outbound transactions. She has led the global transfer pricing projects, including but not limited to pricing policy formulation, implementation of transaction models and pricing policy, intangibles planning, as well as pricing adjustments in various ways.
- Ms. Kuo has been serving technology, media and telecommunications service companies for years in the area of cross-border tax issues and transfer pricing matters.

Professional Accreditation and Certifications

- Ms. Kuo is a Taiwanese certified public accountant (CPA), as well as a Chinese CPA. Since Taiwan was listed by Euromoney as one of the jurisdictions of transfer pricing service providers survey since the introduction of Taiwan TP rules in 2004, Ms. Kuo had been named the leading TP advisor consecutively every year. After her move to Deloitte China in 2010, she has been named the China leading TP advisor by Euromoney since 2011. She was also named the best female TP advisor in Asia Pacific by the Legal Media Group.

Ms. Kuo is a frequent speaker at public seminars and also trainings of tax authorities. She has also been active in associations in Shanghai and has been invited to speak for foreign enterprises and local companies in China.

questions about location-specific advantages, and be ready to reasonably justify their current models. Strong transfer pricing policies and documentation are a good start, but

more will need to be done. This is an evolving issue in China and it seems likely that it won't be long before more APAs and disputes refer to location-specific advantages.

VAT considerations for e-commerce

Nehal Radia considers the VAT implications of e-commerce and how taxpayers can take advantage.

According to Forrester Research Inc, US e-commerce spending will increase by 13.4 % to US \$262 billion this year, with an expected continuation in growth to \$370 billion in 2017. In Western Europe, it is estimated that 2013 e-commerce spending will reach €128 billion (\$165.5 billion), up by 14.3 % from last year and with expectations of €191 billion (\$247 billion) by 2017. With both double-digit compound growth year on year and the continuing introduction of novel ways of trading across the internet, how can taxation, specifically value-added taxation (VAT), keep up?

To date, many commentators might say it hasn't. Especially in Europe, many consider that the VAT concepts that originated in the late 1970s and 1980s, which were designed to apply to "brick and mortar" sellers, do not sufficiently lend themselves to the way businesses and people buy and sell today, despite efforts to update and modernise the tax regime.

VAT is a tax on transactions and applies to most goods and services. In the context of e-commerce, with the sale of digitised products, there is a greater challenge for both sellers and purchasers in defining what is being sold, who is selling, for what price, and where. We will examine some of the main VAT considerations for e-commerce in the EU and more widely.

VAT fundamentals

VAT is more than a European tax. VAT applies in over 150 countries worldwide, and all the OECD countries except the US have a VAT system. The current average OECD VAT rate is 19 %, and VAT accounted for on average 18.7 % of total tax revenues in OECD countries in 2008. Given the trend to increase VAT rates, the significance of VAT for governments in terms of revenue generation, and correspondingly for businesses to manage, is increasing.

VAT principles apply to supplies of goods and services. For VAT purposes, goods are generally defined as tangible personal property and services are broadly considered to be anything that isn't a supply of goods.

Having defined what is being sold, it is necessary to determine the place of taxation and the rate that applies. Different rules apply to sales to businesses (B2B) and sales to consumers (B2C). For B2B sales, VAT regimes generally provide accounting simplification measures, and the tax is, in principle, recoverable. It is in respect of B2C sales that the VAT is potentially an increase to the sales price or a reduction in profit margin. It is also usually with B2C sales that it is the responsibility for the supplier to collect the tax. These complexities are discussed further below.

E-commerce is defined as the buying and selling of products and services by businesses and consumers through an electronic medium. This includes indirect e-commerce, whereby the internet is effectively a virtual store for the purchase of

goods, which are physically delivered. Indirect e-commerce also extends to services such as the purchase of flights, hotels, or services that are physically delivered or performed. In contrast, direct e-commerce covers products and services that are digitally delivered, such as downloaded music, books, and software.

Direct e-commerce poses the greatest challenges for VAT, and that is the primary focus for this article. Supplies sold over the internet are generally considered to be supplies of services for VAT purposes. The definition of so-called 'electronically supplied services' in the EU include products and services which are delivered over the Internet or an electronic network, where their nature renders the supply essentially automated and involving minimal human intervention, and whereby it is impossible to ensure the delivery in the absence of information technology. The definition of these services is broader than an ordinary definition, and includes digitised products and what may be referred to as "intangible goods," such as electronic publications, applications (apps), and software.

There are specific rules covering the EU taxation of electronically supplied services, and currently a distinction is made between a sale through an EU establishment compared to a sale through the US. A US business will need to collect VAT at the rate applicable in each country where its customer is located. Whilst in principle this could require VAT registration in each country where the customer is located, the EU has a simplified regime whereby the US business can register in just one country and collect taxes for all 28 member states. The important distinction is that an EU-established business will charge only the rate applicable in its own country to all customers, regardless of location. However, in 2015, the rules will change and all businesses, whether established in the EU or not, will have to collect VAT at the rate applicable in each country where the customer is located.

Outside the EU, the position varies. Generally, legislatures in some countries – including South Africa, Switzerland, and possibly Japan in 2014 – are becoming increasingly focused on taxation at consumption. However, in the Asia Pacific region and Latin America, the position is somewhat inconsistent, frequently driven by the existence of a local establishment. In such cases, the challenge is how to collect tax at consumption, given that there is no concept of registering just for VAT purposes. A business is generally required to have a local establishment to register for all taxes, and it would be necessary to fundamentally alter the local tax regime to accommodate this. Turkey is currently engaged in this debate, and is considering the possibility for individuals to be responsible for declaring the tax. Based on the ineffectiveness of self-declaration by individuals in other countries, we don't expect this to be the final outcome.

Considerations

Distortion of Competition?

The current differentiation in treatment in the EU of sales made by non-EU and EU businesses and rates varying in the EU from 3 % to 27 % can have a significantly distortive effect. Many providers set up in low-tax jurisdictions such as Luxembourg to capitalise on this. However, in 2015, the rules will change and all businesses, whether established in the EU or not, will have to collect VAT at the rate applicable in each country where the customer is located.

In the publishing industry, a mere difference in the mode of delivery of the printed product can change the nature of the product, the place of supply, and the rate of taxation. The main difference in VAT treatment between the supply of print versus digital is the applicable VAT rate, with some countries applying a significantly reduced rate to print publications. This rate arbitrage between products and between EU countries is currently the object of significant attention and debate at the European Commission and we expect to see further changes in the rules regarding rates that may level the playing field.

There is also room for distortion of competition outside the EU, where, as mentioned above, it is often advantageous for businesses to sell from outside a country rather than from within. Some countries, including Japan, South Africa, and Turkey, are trying to address such distortion, whereas in other countries, such as Australia, the distortion of competition in e-commerce has not yet been addressed and does not appear to be on the tax authorities' agenda.

The e-commerce environment has given rise to the increased use of aggregators or agents to sell globally. Based on the different rules for businesses with an establishment and those without an established business presence, it is conceivable that different sellers of the same product could be taxing the same product differently. It's important to look carefully at the terms of the arrangement to address questions including: who will account for VAT; are the seller and the aggregator/agent jointly and severally liable for the payment of the tax; who dictates the sales price; how are commissions calculated?

Consolidated product sales

We have been discussing mainly direct e-commerce and the sale of digitised products, but there are additional challenges for businesses that sell both digital and print products, particularly as a bundled offering. This is again, a particular issue for publishers who often sell digital and print versions as a consolidated supply where there is a difference in the rates applicable to print and digital products.

When a business supplies a mixture of digitised and print products, for VAT purposes the supply could be treated as a single supply of either print or digital, with an incidental or ancillary supply of the other. Alternatively, it could be treat-

ed as two supplies, one digital and one print. There are no set rules in EU VAT legislation on what determines whether a supply should be treated as a single supply or a mixed supply for VAT purposes. However, this issue has been looked at in numerous VAT cases that have established the principles to help determine the correct VAT position. These principles include examining the core features of the transaction and not artificially splitting a transaction. The existence of a single price is not decisive.

In determining whether a supply is ancillary to the principal supply, one of the key questions to consider is whether the supply can be regarded as 'a means of better enjoying' the principal supply (that is, the ancillary supply is not an aim in itself for the consumer). Outside the EU, similar considerations apply, but there is less prescriptive guidance.

In determining the allocation between two supplies (which can be important when the supplies have different VAT rates) there is relatively less precedent, but tax authorities generally require that a fair and reasonable allocation be applied. Given the subjectivity, the price allocation may be an area in which businesses can gain a competitive advantage but tax authorities, particularly in the EU, are closely scrutinising this allocation, and challenge to aggressive positions can be expected. Common methods of allocation are selling price or cost. Other factors that are likely to be considered include customer perception, usage, and content differentiation.

This is not just an issue for publishers, but all e-commerce providers selling different products. Even if rates don't vary, the way to account for VAT will often vary (goods or service) and the invoicing and compliance associated with such transactions gets complicated.

Compliance and reporting

E-commerce creates VAT compliance and reporting obligations for business that can be challenging and burdensome. In addition to the requirement to maintain VAT registrations, file periodical VAT and other statistical returns, there are a number of other considerations that are particular to the industry.

Because taxation is based on consumption, it is necessary to determine where consumption takes place. The rules vary in different jurisdictions and often the billing address alone will not be sufficient for this assessment. The EU recently issued draft regulations providing specific rules to determine the place of consumption where there is the potential that the customer is established or resides in more than one country.

These guidelines make reference to different presumptions based on the circumstance in which the supply is made. Relevant factors include permanent address, billing address, location of WIFI hotspot, and IP address. Under the new guidelines, two items of evidence are generally required to determine where the customer is established, has its perma-

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Experience

Nehal is a senior manager in our US-based global VAT practice. She has over 15 years' experience in indirect taxes working in both the UK and the US, advising global multinationals on VAT/GST matters. She has practical knowledge of worldwide VAT systems, advising businesses on their expanding international operations principally in Europe, and also in Asia Pacific and Latin America.

Nehal has managed numerous global consulting and compliance engagements assisting companies managing VAT globally, including the efficient set-up of operations and VAT recovery. She has extensive experience in co-ordinating and managing large teams within our organisation, having worked in an in-house role supporting the management and development of Deloitte's Global Indirect Tax network. She also has experience in the area of indirect tax technology with a focus on the enhancement of compliance processes and risk management.

Nehal has a wide range of industry experience, particularly in the technology, media and telecommunications and consumer products industry.

Nehal regularly presents at internal and external seminars and conferences on international VAT/GST matters.

Nehal is a qualified UK solicitor, a chartered tax adviser (ATII) and a member of the UK Chartered Institute of Taxation.

nent address, or usually resides. It can be challenging for businesses to capture the relevant information and verify it.

Setting up accounting and billing systems, as well as customer interface, can be complicated. It will be necessary, for example, to:

- Capture the relevant tax rate information per country for both print and digital products, where applicable.
- Differentiate between business and individual customers, if both markets are being served.
- Identify relevant information in respect of customers to determine the place of supply – permanent vs. billing address, VAT registration number for businesses, etc.
- Apply the correct price and taxability for the products

sold, with particular attention to the pricing considerations discussed above with regard to bundled products.

- Include relevant information on the customer interface on the website.
- Issue appropriate invoices, where necessary.

Fraud

Fraud is already a significant concern in the VAT arena. According to the OECD, revenue loss from VAT fraud and avoidance is running at 10 % and in some instances, at 30 % of potential VAT revenues. The EU is generally concerned with “Missing Trader Intra-Community” (MTIC) fraud. Missing-trader fraud arises when a business purchases goods or services as part of an intra-community transaction without having to pay VAT to its supplier, collects VAT from its customer on the subsequent domestic supply, and then disappears without having paid the tax to the tax authorities.

MTIC is an indirect e-commerce play, but the virtual market place, with the lack of information required to be provided by supplier and consumer, the ease of payment, and the scale of access to markets provides a fertile ground for fraud to thrive across all areas of e-commerce.

More generally, suppliers can sell on the internet without meeting VAT obligations, resulting in lost VAT revenue and distortion of competition arising from suppliers not collecting VAT where they should. Furthermore, fraudsters could collect VAT but not remit it – a clear loss of VAT revenue to the relevant government. There is also scope for potential ‘fraud’

by consumers. Given that suppliers have to rely on evidence provided by consumers regarding their location and the place of consumption, there is some potential for VAT-rate shopping through the provision of preferential billing information. This is more likely to result in the misallocation of VAT in the EU rather than nonpayment and lost VAT revenue.

Changes on the horizon?

Given the complexity, the rapidly changing business environment, and the significant variations in rules and rates of taxation, it is difficult for e-commerce businesses to have a clear and consistently applied global approach to VAT.

There is recognition at the EU and OECD levels that something must be done to simplify the rules and level the playing field in terms of rates and rules and there is some progress, but this is slow.

In the meantime, it is important to have an awareness of the key principles and trends involved, and to be mindful of the potential pitfalls of expanding into new countries. More specifically, taxpayers should be aware that although in many countries taxation increasingly focused on the place of consumption, being a virtual seller does not always preclude creating a physical presence for VAT purposes. It’s also not always about a down-side. There can be scope for potential tax reductions and with an average OECD VAT rate of 19%, this is particularly relevant for B2C sales, where any changes in the VAT treatment can have a notable impact for businesses on competitive pricing or profit margin.

Building a flexible global business platform

As tax executives, we have always seen change as an opportunity. However, at today's pace of change, successful tax executives are finding that opportunities come and go quickly, leaving behind risk. **Daniel Munger, Andrew Newman and Sophie Blegent-Delapille** explain how to build a flexible global business platform.

Multinational enterprises continue to shift portions of their value chain to global and regional platforms to achieve business efficiencies. Technology advances are enabling organisations to connect globally and “franchise” their business models to create globally integrated enterprises. Digitally driven processes and the use of data are emerging as value drivers. While traditional stakeholders, such as the C suite and board members, continue to view tax management as driving value, new stakeholders have emerged, including media, consumers, and employees. In the meantime, local governments are focused on eliminating deficits and are showing a more aggressive enforcement activity to collect taxes. Given all these changes, what are the key implications for managing global tax in the future? We will discuss the need for a flexible model that can accommodate change and the increased focus on communicating with business leaders.

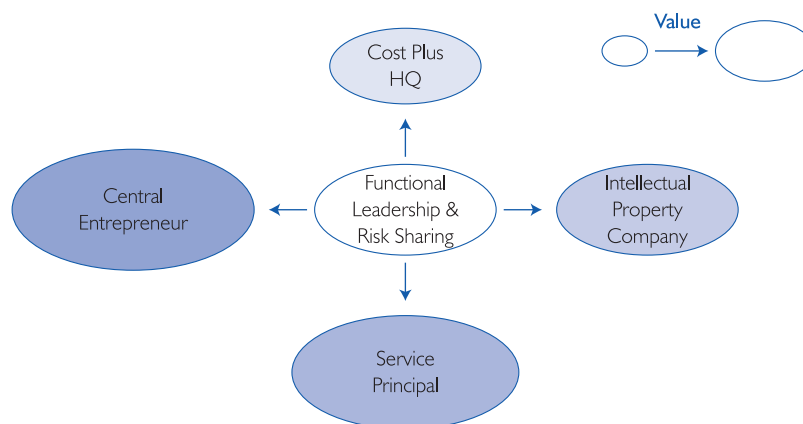
All the change in today's environment has disrupted the focus of traditional global tax planning. More than ever, transfer pricing plays a central role. International tax management is no longer primarily focused on transactions or legal restructuring. Today one of the key responsibilities of tax executives is understanding the current business model and the key strategic initiatives driving the future of the company's organisation. Managing a global tax posture that is driven by the business model requires a different skill set. Effective global tax management now requires the tax executive to have a seat at the table with management and business segment leaders for two important reasons: (i) the exchange of information on what's happening in the business will help both teams move forward in a much more efficient manner; and (ii) tax executives are now first in line to provide support for the company's tax position to a variety of new stakeholders, in addition to the tax authorities.

In addition to understanding the organisation's business model, tax executives must now be actively engaging in the process of Business Model Optimisation (BMO). This requires an understanding of different operating models, underlying transfer pricing methodologies and legislative direction. The chart below summarises the primary BMO alternatives, all of which are driven by distinct transfer pricing principles.

Alternative BMO models

The traditional BMO model is referred to below as a central entrepreneur (CE). The CE is an operating company that manages key functions that drive profitability, funds innovations, and manages risk. The local operating companies act as limited-risk distributors, or cost plus service providers. At the other end of the spectrum would be a centralised cost plus service provider that functions as a headquarters (HQ) providing guidance and routine management services to the local operating companies, rather than a centralised operating company that provides the strategic control and

Diagram 1: Alternative BMO Models



oversight of the local operating companies, as would a CE. Within the spectrum of alternatives is a pure intellectual property (IP) manager and owner (IP Company), providing the use of the IP rights to the local operating companies by means of license agreements. A more substantive BMO model than a pure IP company has emerged in recent years. We call this enhanced BMO model a Service Principal whose functions are strategic for the group, and that delivers added value services and leading practices. The Service Principal may have IP embedded in the services it provides, in which case it takes on characteristics similar to a franchise arrangement. However, the Service Principal model and the IP models can work side by side rather than being combined, as discussed below.

We will discuss how to combine these alternative BMO models to create a flexible BMO platform that accommodates the multiple fact patterns within a group, and more importantly, accommodates change.

Let's use the technology, media & telecom (TMT) industry as an illustration. The TMT industry has at least two primary areas of focus that drive BMO: TMT "content" and the TMT business model. The BMO IP models generally apply to content. These models can be complex due to profit sharing, joint ventures, and risk management. New content models are emerging to capture the value of data. This article will focus on the evolving TMT business model and how to increase value and manage change using a flexible BMO model. The flexibility concept may also apply to the "content" models within the organisation.

The premise of a flexible BMO platform is that, in an ideal world, significant components of the value chain would be centralised in a single, tax-efficient country where the func-

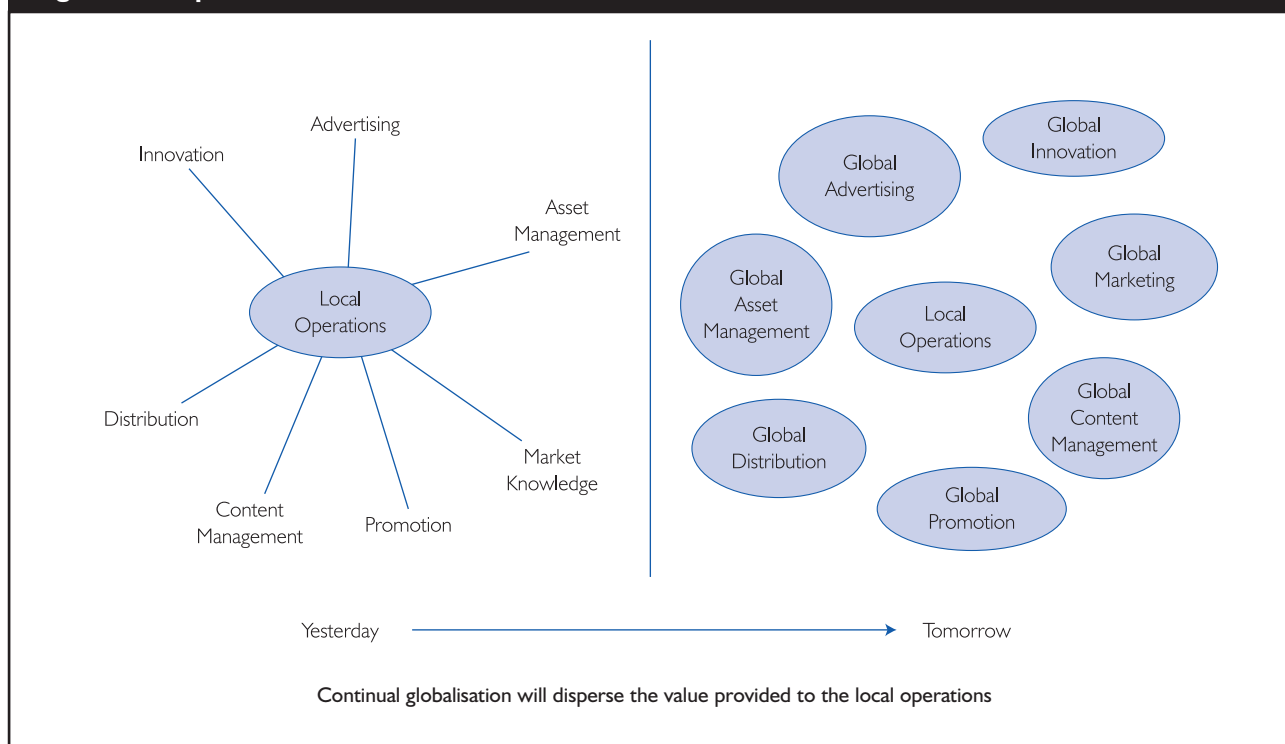
tions and risks are managed and deployed for the benefit of the local operating companies. A common term for such a structure is a "hub". When these hubs are formed as "virtual Hubs" without regard for geographic boundaries, opportunities may be lost. These hubs have emerged as a result of value creation being driven by global or regional functions located outside the local operating company, whereas at the same time the value created in the local operating company decreases. The functions within the local operating company may be solely execution and local relationships. In fact, TMT business models are increasingly looking like a classic franchise model. This dispersion presents potential opportunity when it can be located within a BMO model, as opposed to being dispersed as in the case with a virtual hub.

Dispersion of the value chain

This dispersion may start small (purchasing, information technology) and evolve over time. Any significant movement toward regionally or globally managed functions provides an opportunity to start building a tax-efficient BMO platform. A flexible platform starts with the creation of a solid core of functionalities around a hub that can grow as new globally or regionally managed functions evolve over time. The hub platform may have geographic focus (Asian hub in Singapore and EMEA hub in Ireland, Switzerland, Netherlands, for example) and flexible platforms may integrate multiple hubs in a manner that reconciles their value add so as not to create an unbalanced transfer pricing situation.

Over time, a hub may add functionality or increase risk management. This "top down" approach creates an increased level of value at the hub. Flexible BMO platforms accommodate change for the top down approach. Failure to identify

Diagram 2: Dispersion of the Value Chain



top down changes can result in lost opportunity, but also tax risk. Organisations will continue to move toward global and/or regional functionality, process standardisation, resource sharing, and centralised asset management. For example, if we examine the functionality of a BMO model created five years ago, we would expect to see an increased level of functionality.

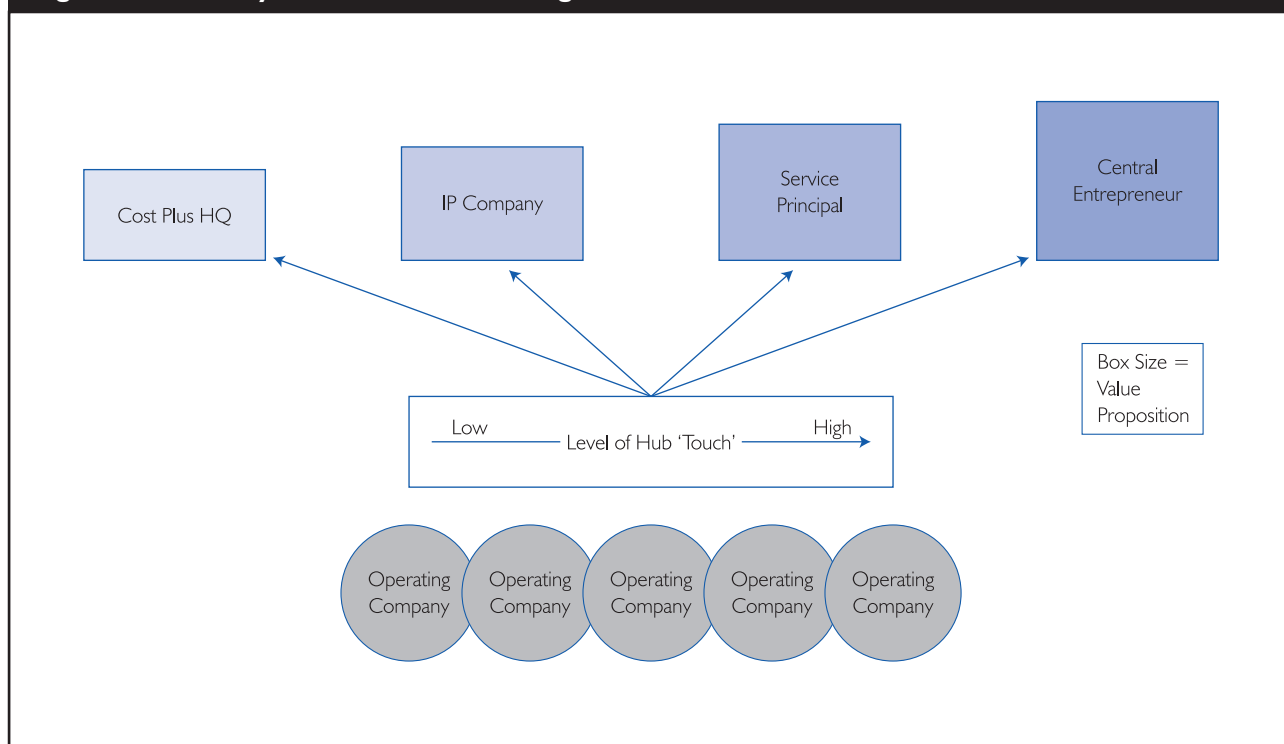
Managing an existing BMO structure from the top down requires deeper communication with business segment leaders and the C-Suite. Management needs to understand the underlying principles of the company's operating model(s) and be aware that change creates both opportunity and risk. This is especially true in cases where physically locating the management and funding of new initiatives in the Hub can generate incremental savings for the business to reinvest. Management communication is effective only when it moves past concept and toward reality. The use of analytics and scenario analysis will clarify the message. Communication becomes more important in today's environment, because management must respond to the different stakeholders, including the media, employees, and tax inspectors.

Equally important, the flexible BMO model must accommodate change from the bottom up. Bottom up change relates to the increasing level of reach within the global organisation. As more of the organisation receives the benefits of the evolution of the operating model, the expected results are

increased revenues, cost reduction, or both, creating margin improvement. Over the years, the increased coverage results in more value creation outside the local operations. Keeping close communications with the hub allows the identification of bottom-up change. Including larger portions of the local operating companies within the BMO platform represents opportunity. For example, the flexible BMO platform allows some countries to participate in a CE model, while others participate in a Service Principal model or an IP Company model.

Failure to identify bottom up changes can result in added risk. As local tax authorities demand more transparency, they will likely inquire about hub activities and compare and contrast. For example, a hub created five years ago in Singapore may have included Japan in the model under a limited-risk model (Japan earns a commission under a CE model). During the Japanese tax audit, it was discovered that the hub recently began providing substantially the same level of functionality to China (which historically paid the hub for routine services). The Japanese tax authorities will likely ask for reconciliation of the two profit profiles. In fact, in Europe, the tax authorities are more frequently seeking input from other tax authorities, and are looking to manage audits on a coordinated basis. With respect to bottom up change, the difference between opportunity and risk is continual communication with hub management and business segment leaders.

Diagram 3: Flexibility to Accommodate Change



It is not uncommon for many organisations to have undertaken BMO alignment focused on the CE model. However, the use of such a model has frequently not been possible in some jurisdictions, particularly in Latin America. An increasingly common situation involves a regional CE model that has evolved over the years and now may be providing all its services to a number of affiliates in countries that are not part of the original CE model transformation. In many cases, those local operating companies may not fit a limited-risk model despite receiving practically the same level of functionality and risk management commonly associated with a CE model. These restrictions may include regulatory issues, indirect tax costs, and local-country permanent establishment risk. The value added services provided by the hub do not fall within the definition of “routine services”. A flexible BMO platform may allow this country to be included under a Service Principal model to reflect the value added services. The local operating company would continue under the existing IP model, or the IP could be integrated as part of the Service Principal model. If combined, the Service Principal would license (or acquire) the IP and the value of the IP would be reflected in the fee charged to the local operating company.

The Service Principal Model provides a link to allow a flexible BMO platform. The flexible BMO platform is built on a core of functionality that is accessed by the local operating companies at different levels of ‘touch.’ There are many fac-

tors that determine which of the BMO models apply to a particular operating company, including local-country regulatory issues.

Flexibility to accommodate change

As discussed earlier, the Service Principal model reflects the provision of value added services to the local operating company. It is essential to the flexible BMO platform because it can stand alone as a provider of high value services, be potentially combined with IP, and also enhanced through risk management activities. Separate transfer pricing policies can be supported for each of the BMO models and reconciled in a manner that reflects their individual value proposition. This flexibility can be applied on a country-by-country basis, as illustrated above. Criteria for moving from one BMO model to another model (Service Principal to CE, for instance) can be established based on the level of touch or other relevant factors that indicate the value the hub provides to the local operating company.

A stable platform requires transfer pricing that can be reconciled and justified to the local tax authorities. For example, a local operating company may make service payments under a Service Principal model and separately make IP payments to the IP owner, each payment supported under the appropriate transfer pricing guidance. Care must be taken that the two payments can be reconciled. Franchise agreements often pro-

Biography



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Mr. Munger has more than 30 years of tax and accounting experience delivering global tax and treasury strategies to Fortune 500 multinational businesses. His focus on strategic international tax consulting for multinational organisations includes U.S. and local county tax planning for mergers and acquisitions, supply chain transformation, intellectual property alignment, service principal companies, foreign tax credit planning, treasury strategies, repatriation, cash mobilisation strategies, and strategic transfer pricing.

Mr. Munger is the Global leader of the International Strategic Tax Review (ISTR) practice. This global practice within Deloitte Tax delivers holistic strategic planning to ensure long term sustainable effective tax rate reduction. In this role, Mr. Munger has assisted many U.S. and non-US multinationals in designing integrated tax and treasury strategic plans and executing multi-year strategies. The Global ISTR practice consists of a team of professionals that have developed specialised tools, models and processes that facilitate in the design and implementation of global tax and treasury strategies.

Mr. Munger is also the US Market Strategy and Innovation Leader for the International Tax Practice and is focused on connecting the many diverse skill sets within Deloitte to bring value to clients. In this role, Mr. Munger looks to the challenges our clients face in developing, executing and maintaining global tax strategy in order to identify new initiatives and solutions. An example is the use of data analytics and interactive tools for strategy development and monitoring.

Mr. Munger has also played a key role in various international think-tank efforts and has been a contributor to the development of innovative tax solutions to support client business strategies. Mr. Munger is a frequent lecturer on a variety of international topics and tax accounting matters with groups such as the Tax Executives Institute, MAPI and the World Trade Institute.

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Biography



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Andrew Newman is a tax partner specialising in international tax matters for multinational companies (MNCs). With more than 30 years of experience, he serves multinational clients in a variety of industries, including manufacturing, services, specialty chemicals, fast-moving consumer goods, food processing, and distribution and franchising.

Mr. Newman is the Co-Global Leader of the Business Model Optimisation (BMO) service offering. In this role, Mr. Newman is heavily involved in working with MNCs in optimising their supply chains and operating models and the tax benefits that can flow from such business transformations. This has included the design and implementation of principal and intellectual property company structures for Europe and Asia. BMO focuses on creating value through business transformation.

Mr. Newman has performed numerous global strategic tax reviews for MNCs to focus on reducing their worldwide effective tax rates. In addition, he has been instrumental in pioneering a new approach to managing the effective tax rate of a global company while optimising its utilisation and repatriation of offshore cash. He has successfully implemented this Global ST2EPS methodology for many U.S.-based multinational companies.

In a highly regarded international survey on tax advisors, Mr. Newman recently was recognised as one of the leading international tax service professionals in the central region of the United States. The study, conducted by the *International Tax Review*, gathers and assesses feedback on accounting and law firm tax advisers from 2,000 in-house tax experts and chief financial officers at major companies and financial institutions throughout North America. Mr. Newman is also listed as one of the 2010 World's Leading Tax Advisor's.

Mr. Newman has published several articles on international tax matters in such magazines as *The Tax Executive*, *Investment USA*, and *The International Tax Management Journal*. Mr. Newman is a co-author of the *BNA Portfolio on the Allocation and Apportionment of Deductions*. He has spoken on international tax matters to various tax groups, including The Chicago Tax Club, the Tax Executives Institute, CITE, the International Fiscal Association, and the National Chamber Foundation.

Mr. Newman is a member of the International Fiscal Association, the American Institute of Certified Public Accountants, and the Illinois CPA Society.

vide the best support for determining the appropriate fee under the Service Principal model. When using franchise agreements as transfer pricing support, it must be recognised that these agreements generally include an IP component. In the example above, the range of franchise fees from comparable franchise agreements must be reduced to remove the IP component.

Analysing the international tax consequences of the Service Principal model requires coordination between international tax and transfer pricing practitioners to conclude that the local operating companies are being provided value added services as the primary component and the appropriate level of intellectual property. This issue receives additional attention when using franchise agreements to support the transfer price, because the fee may be calculated as a function of revenue. While justified from a transfer pricing standpoint, tax authorities' initial reaction may be to call it a royalty. Royalties may be subject to withholding tax, whereas services are generally not subject to withholding if the services are provided outside the local operating company's country (other than in many Latin American countries). For US multinationals, the distinction between services and royalties has a direct bearing on the tax efficiency of the hub. Management needs to be aware of the need to support the provision of services and the value provided to the local operating company.

In most cases, in real life instead of in an ideal world, operating models rely not only on resources employed by the hub, but also on resources employed by affiliates in other geographies. The hub typically reimburses these shared service centre operations for such activities under a cost-plus service fee model. It is important to determine the activities and management of such individuals to avoid creating a permanent establishment for the hub in the country where the contracted work is performed. In addition, indirect tax may be levied on cross-border service fees. These taxes may influence the choice of operating models, because in some countries the indirect taxes may create significant additional costs if not fully recoverable.

Despite the complexity, change can bring opportunity to those who have a flexible BMO platform and good lines of

Biography

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Sophie Blégent-Delapille is an international tax partner in Deloitte's Paris office (France). Sophie has over 22 years of tax experience and leads the corporate tax practice in France, which includes international tax, business tax and M&A. Sophie also leads the Deloitte EMEA International Strategic Tax Review market offering to assist multinational European groups in the alignment of their business strategies with a sustainable tax profile. She specialises in International tax, focusing on large cross border projects, including business model optimization and IP projects, mergers and acquisitions, tax combination and consolidation strategies. Sophie also advises Private Equity Houses in their French investment strategies.

Before joining Deloitte in 2002, Sophie was a tax partner at Arthur Andersen.

Sophie is attorney at Law, with a Business and tax Law degree obtained at Paris II University, as well as a finance and accounting degree obtained at Paris II.

communication within the organisation. So, where do you start? Does your existing hub need a refresher? Is your organisation just beginning to globalise or regionalise, either virtually or physically, portions of its value chain? In either case, it starts with analytics to understand margins and cost pools; engaging with management to identify global or regional initiatives that create value; and performing an analysis to develop a high-level understanding of the impact of alternative BMO models. Executing these tasks will provide what is needed to build a flexible BMO platform, better after-tax decision-making, and sustainable tax savings.

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