2017 Corporate Tax Spring Training

Transfer Pricing and International Tax Update

Agenda

Evolving landscape

- BEPS: Application and Implications
  - Dutch CV/BV
  - Lux HoldCo with Swiss Principal Company and IPCo
  - Non-resident Irish company
- PE Issues
- Value Chain Analysis
- Economic Profit Split
- Potential Tax Reform Implications

Evolving landscape

BEPS overview
Substance requirements

To be entitled to IP return

- Must control operational risks – meaning “DEMPE” Functions (development, enhancement, maintenance, protection, exploitation)
- Thus, IP return has shifted from financial capital to people functions
  - Financial capital gets a projected risk-free return or a risk-adjusted return
  - The OECD has not agreed on what to do with actual returns (who gets the unanticipated upsides)

Controlling operational risks requirements for each operational risk

- In-location people that
  - Are qualified, have decision-making authority, demonstrate in-location exercise of decision-making authority as it relates to risk mitigation
  - No in-location white lab coat requirement or headcount requirement
  - Board meetings are no longer sufficient
  - Setting procedures and policies no longer sufficient

BEPS overview
Cost sharing

Qualified Cost Sharing Agreement ("QCSA")

- No control requirement
  - Changes to Treas. Reg. § 1.482-7 to introduce control requirement possible
- In a QCSA, the U.S. will not go after the rest of world ("RoW") IP return – foreign tax administrations of DEMPE functions will
- Without operational substance, risk that additional IP return could go to Exploitation

Non-Qualified Cost Sharing Agreement ("NQCSA")

- Control requirement under Treas. Reg. § 1.482-1(d)(3)(iii)(B)(3)
- In a NQCSA, the U.S. can arguably go after RoW IP return – foreign tax administrations of DEMPE functions will as well
  - Thus, without operational substance in IPCo, IP return will be contested
- Countries exploiting the IP as "E" providers

Takeaway: Move "DEMPE" Substance to IPCo

BEPS overview
Substance requirements

Business as usual from U.S. perspective, unless or until regulations amended

- Funding U.S. research and development ("R&D") via CSA or contract R&D still viable
- Creates dichotomy between U.S. vs. BEPS, whereby U.S. respects offshore funding and other countries do not

Low tax income still possible, but…

- Must establish that offshore income attributable to U.S. R&D, not to onshore "people"
- May require sophisticated global profit split
- CbC reporting will highlight

For non-U.S. R&D, orientation of DEMPE functions key to offshore funding

- Will need at least DEMPE supervision in IPCo
- May still be exposed to local profit split

Increased controversy very likely as countries take differing approaches

- Key role for MAP

For new IP migrations, can expect greater use of income method / DCF valuations

Changes to Transfer Pricing guidelines – BEPS Actions 7

- BEPS Action 7 focuses on preventing the artificial avoidance of permanent establishments ("PE") and includes the following changes:
  - BEPS changes lowers the threshold for when a PE arises, the nature of the PE (deemed PE) has not changed
  - Formal considerations around arrangements could convert a commissionaire/agent into a PE
  - Warehouse operations are not considered "ancillary" activity and thus no longer exempted from being fixed places of business for PEs
  - Anti-fragmentation rule that removes exceptions in circumstances where activities in a country are carried out by different group companies, where the activities are part of a "cohesive business operation" and not, in the aggregate, preparatory or auxiliary

Changes to Transfer Pricing guidelines – BEPS Actions 8-10

- BEPS Actions 8-10 focus on "aligning transfer pricing outcomes with value creation"
  - General premise is that value is created by physical assets and people functions, <u>not</u> by financial capital
  - General goal is to prevent taxable income to accumulate in "highly capitalized low functionality" entities ("cash-boxes")
  - General approach to achieve goal is to require the "testing" of contractual risk allocation
- To be entitled to the return to a risk you now have to demonstrate that you exercise "control" over the key decisions that affect the risk outcome, and that you have financial capacity to bear the risk
- In typical IP companies you may have people who "control" the financial investment decisions, but "control" over the R&D activities take place elsewhere
  - In that case the IP company is only entitled to a "risk-adjusted return"

IRS issues final section 367(a) and (d) regulations

- The U.S. Department of the Treasury and the Internal Revenue Service on December 15 issued final regulations under section 367(a) and (d) of the Internal Revenue Code that coordinate the valuation rules of sections 367 and 482:
- When property is transferred to a foreign corporation pursuant to section 367, the value of such property must be determined under section 482
- The useful life of intangible property transferred under section 367(d) is no longer limited to 20 years, although taxpayers may make an election to include the entire amount of the property's value in the annual inclusions over a 20-year period
- The definition of the term "useful life" has been revised to account for the fact that exploitation of intangible property can result in both revenue increases and cost decreases
- The IRS and Treasury continue to maintain that intangible property may have an indefinite useful life if it is used in the further development of the next generation of that intangible or of other property

Key Changes

Application and Implications

Retrofitting common IP structures for BEPS

Move the substance to the IP

- Redeploy the appropriate people to the IP holding entity
  - May not need to involve deployment to jurisdiction where entity organized
  - Need to also show actual exercise of their roles and authorities
- Review existing substance in IP holding entity and consider recrafting roles

Move the IP to the substance

- Perform ALS valuation of the IP
- Timing should be carefully considered

Consider impact of GAAP repeal of ARB 51 on intergroup transfers of intellectual property

- Current tax expenses and benefits would appear on books immediately, causing more volatility in earnings
- Cost or benefits of transfer before repeal could move to equity or change in accounting

Alternative Centralized Models for PEs

Toll manufacturing ("TM") to contract manufacturing

- Inventory holding function of Principal operating company ("POC") may constitute a PE in TM country, where sales also occur in such country, shifting to contract manufacturer eliminates need to legally own such inventory in the country.

Stockholding limited risk distributor ("LRD")

- POC holding inventory in LRD country may generate PE where POC also has a fixed place of business in LRD country.

Centralized stockholding company

- Establishment of intermediate central stockholding company between POC and non-stockholding LRD.

Business licensing / franchise model

- Remaining the TM and non-stockholding LRD by implementing a business license model.

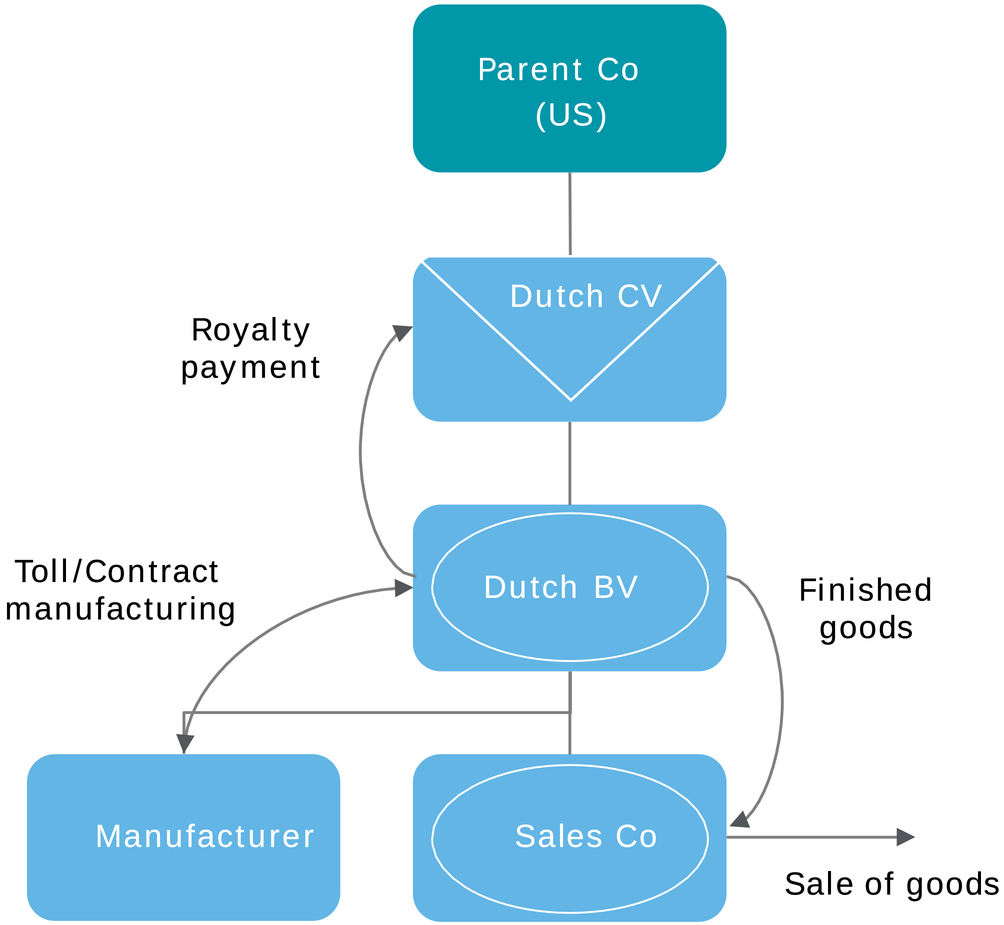
Structure 1
Dutch CV/BV

Key issues in BEPS world

- Hybrid mismatch arrangement legislation – limitations under BEPS Action 2, the EU Directive, UK legislation

Developing, enhancing, maintaining, protecting and exploiting ("DEMPE") intangibles functionality – Dutch tax authorities take a hybrid view

- EU State Aid – rulings do not impact determination
- Country-by-country reporting
- BEPS Action 7 – Permanent Establishment ("PE") issues
- EU CFC legislation
- BEPS Action 6 – beneficial ownership; treaty issues/principal purpose test ("PPT")
- US Subpart F Branch Rule

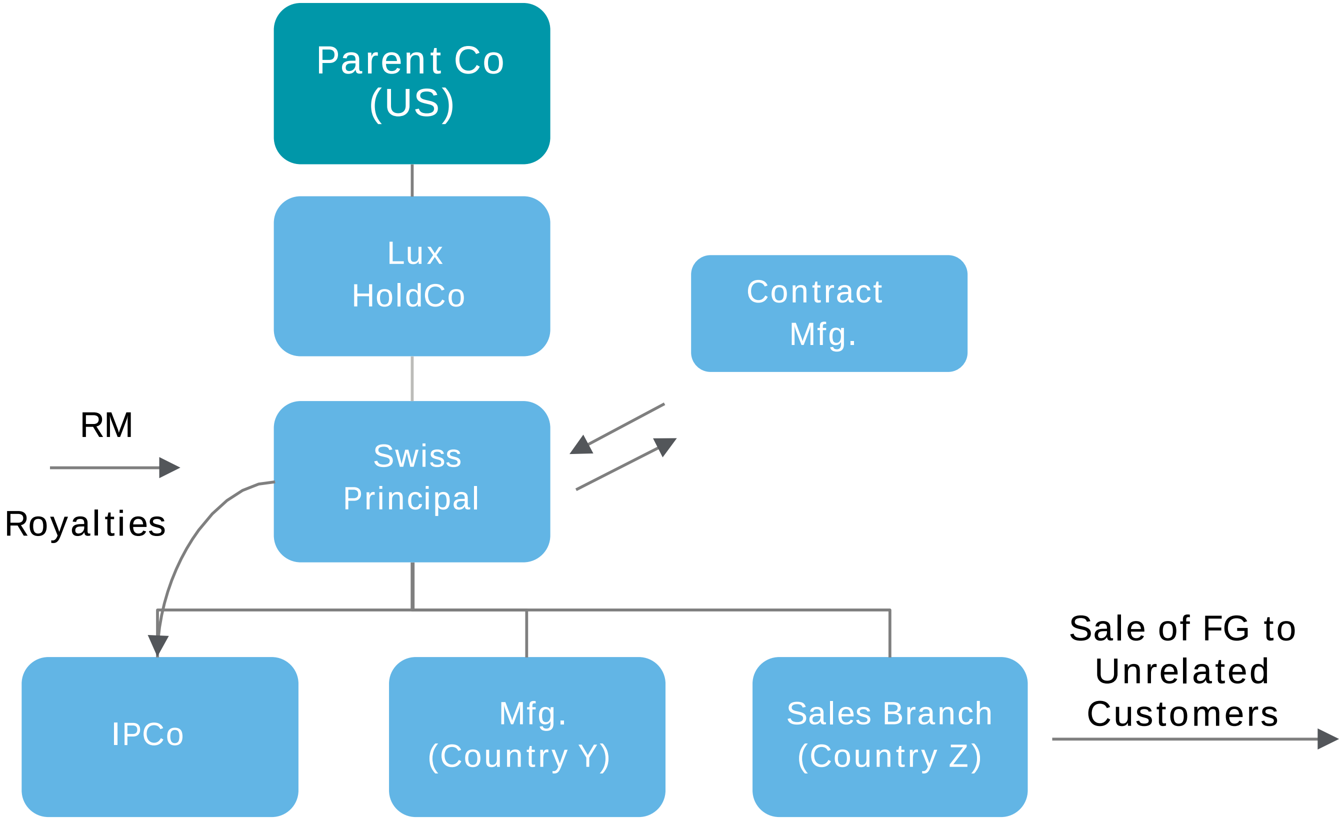


Structure 2

Luxembourg HoldCo with Swiss Principal and IPCo

Key issues in BEPS world

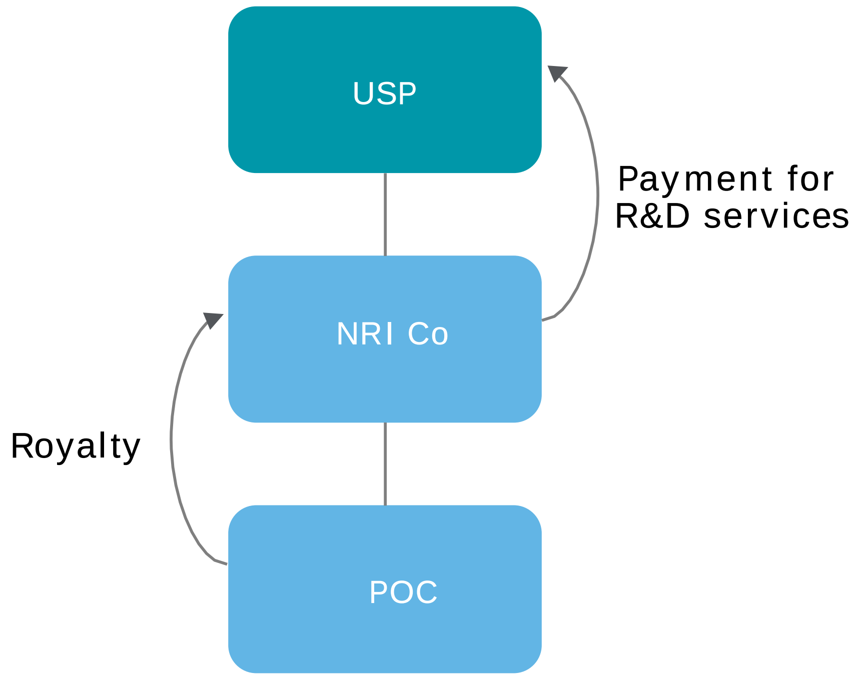
- DEMPE functionality
- Country-by-country reporting
- BEPS Action 7 – PE issues
- EU CFC legislation
- BEPS Action 6 – beneficial ownership; treaty issues/PPT
- US Subpart F Branch Rule
- Hybrid mismatch arrangement legislation – limitations under BEPS Action 2, the EU Directive, UK legislation



Structure 3
Non-resident Irish company

Key issues in BEPS world

- Hybrid mismatch arrangement legislation
  - limitations on the EU Directive, UK
- DEMPE functionality
- US Subpart F Branch Rule
- EU state aid



Value Chain Analysis – definition of “value”

- A Value Chain Analysis (“VCA”) requires a definition of what “value” is
- For tax purpose, “value” is defined as “arm’s length value”—the price at which assets changed hands in the open market
  - The clarification of the arm’s length principle provided in BEPS proposed changed to Chapter I, Section D of the TPG needs to be reflected in the VCA approach
  - The measurement of arm’s length value can be done using DCF (authority: Chapter VI, Section D2.6.3, Paragraph 6.153)
  - An attribution of value based on a formulaic apportionment divorced from Chapter I, Section D of the TPG is rejected by the OECD (authority: Chapter I, Section C.3, Paragraph 1.32)
  - Thus a VCA based on headcounts, location of executives, etc. is inconsistent with the OECD and BEPS requirements

Value Chain Analysis – where is the control test performed

- Each significant contractual allocation of risks is tested as required by BEPS and the fixed costs that give rise to the risk are allocated to the party controlling the decisions in connection with these fixed costs
- Party A may be funding $1,000,000,000 of fixed costs, but if Party B controls all the decisions on how to spend the $1,000,000,000, then Party B is credited with the fixity of these costs and associated risk and return (authority: Chapter I, Section D, Paragraph 1.98). Party A is merely receiving a funding return for the $1,000,000,000 (authority: Chapter VI, Section B2.2, Paragraph 6.61)
- A VCA approach that does not reallocate risk-return based on the “control” test or that does not perform a “control” test of contractual risk allocation results in a formulary apportionment that is rejected by the OECD (authority: Chapter I, Section C.3, Paragraph 1.32)

Deloitte’s Economic Profit Split

- Deloitte’s Economic Profit Split (“EPS”) methodology to gather and process detailed information associated with economic assets is consistent with the arm’s length principle, BEPS and the OECD Transfer Pricing guidelines.

- Deloitte’s EPS follows the arm’s length principle that the economically significant systemic risks assumed by each entity determines the split of the global profit

  − In the market, risks and the expected returns should be aligned
  − Higher systemic risk attributed to higher expected profit
  − Split of global profits for a particular period based on relative fixed cost commitments
  − Split ratio (determined ex-ante)
  − Fixed costs are also the maximum loss potential of parties in the current period
  − Split current contribution margin ex-post using fixed cost ratio

Tax Reform Considerations

Application to IP structures

U.S. tax reform considerations if IP **offshore**

- IP principal companies may continue to operate as planned
  - No increase in U.S. or foreign tax burden on CFC income relative to current law
  - PCT payment to U.S. (if any) is treated as exempt income under Border Adjustment Tax (“BAT“)
  - Consider BEPS legislation impact
- Consider after implementation of BAT, whether the U.S. might become the destination of choice for global principal companies (in either U.S. legal entity or branch formed under CFC)
- Consider local country tax consequences of migration of assets (including IP) and/or activities back to the U.S., including exit taxes, withholding taxes, and local country transfer pricing.
  - Consider state tax implication
  - Assess likelihood of subsequent BAT repeal/modification

U.S. tax reform considerations if IP **onshore**

- If IP is not yet offshore, consider IP migration
  - Consider U.S. tax cost of migration
  - Consider ARB 51
  - Consider territoriality and possible BAT or Minimum Tax on foreign earnings
  - Consider exit strategy in the event of U.S. tax reform
- Consider leaving IP in the U.S. and licensing to foreign subsidiaries if BAT adopted
  - Consider impact, if any, of BEPS hybrid mismatch legislation
  - Assess likelihood of BAT implementation and subsequent BAT repeal/modification
  - Where US Co is the licensor of non-US IP to foreign operations, US Co's pre-existing substance and management functions could be leveraged to demonstrate control of DEMPE functions
- Consider transition tax

Enabling with Technology

Technology Enablement

Key features

Web-based platform:

- Online platform enables an efficient and streamlined documentation process allowing central and local client contacts to collaborate seamlessly

Central management and audit trail:

- A project coordinator and one or more admins can centrally manage the entire documentation process with input from the local entities
- Platform enables central management to review and provide feedback to local users
- Through the dashboard, a clear workflow can be established, allowing control over content and deadlines, including an audit trail

Automatic report generation:

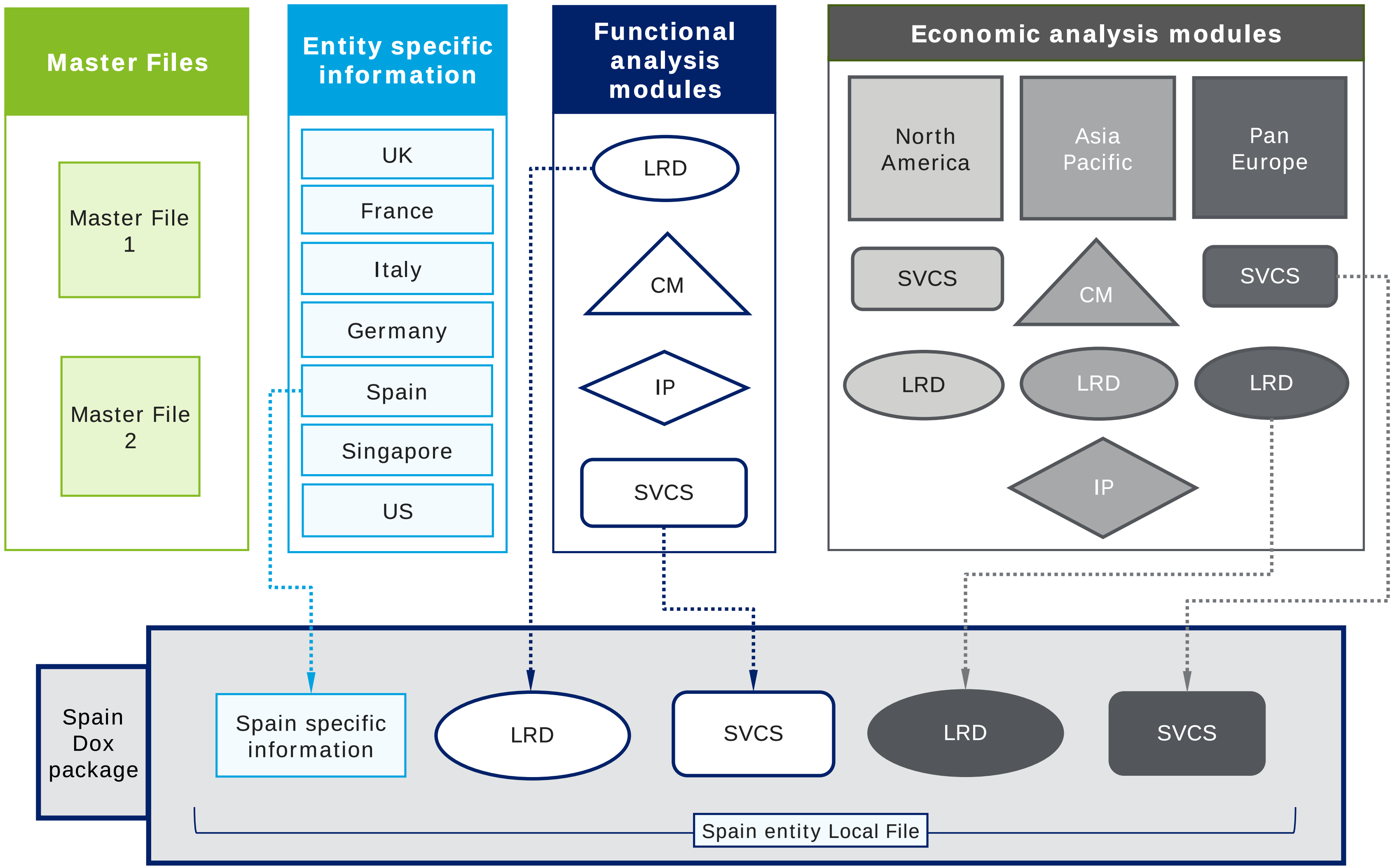
- Customizable questionnaires help to gather factual information in a consistent and timely manner
- Information can then be automatically converted into OECD/BEPS compliant transfer pricing documentation reports
- If information changes, all applicable reports can be updated simultaneously

Time and resource savings:

- Automating data collection and processing enables emphasis on value adding activities by both Deloitte and client teams

Modular approach

A visualization



Benefits of a modular approach to TP documentation

Risk reduction

Minimizing manual repetition, and accordingly the risk of human error and inconsistencies, can result in increased consistency, efficiency, and quality

Streamlined approach

Overlapping information across Master/Local files can be easily leveraged and the relevant information populated/reviewed a single time (rather than repeatedly for each report)

Increased efficiency

Factual and financial changes to overlapping sections of reports can be applied simultaneously and efficiently incorporated into corresponding reports

Focus on value

Automating labor intensive, manual exercises allows both client and Deloitte teams to focus on value added activities

Extendable

Modular approach extends to the potential preparation of multiple Master Files for companies with multiple business units/divisions

Flexible

Easy adaptability to documentation requirements under the OECD’s BEPS Action 13 or other local guidance, when needed