Insights: Transfer Pricing

CRA Charles River Associates

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In this year-end edition of *Insights: Transfer Pricing*, we highlight the work of CRA's Transfer Pricing Practice in 2018, provide a recap of transfer pricing regulations/guidance and litigation, focus on hot topics such as US tax reform and the digital economy, and look at what lies ahead in 2019.

Our consulting work: a year in review

Our consultants help clients navigate every phase of implementing and supporting international tax structures including: intellectual property (IP) and acquisition planning, documentation, and audit defense. We also provide litigation support and expert testimony services in tax and transfer pricing litigation. To follow are some highlights of projects from the past year.

Planning

Against the backdrop of sweeping changes arising from US tax reform, we conducted IP restructuring work for clients involving issues such as the dissolution of a cost sharing agreement (CSA), repatriation of IP, and the movement of IP between different non-US locations. These engagements involved the valuation of complex IP for clients in a variety of industries. The methodologies our transfer pricing consultants used were specifically tailored to each respective client, the industry issues they faced, and the specific facts and circumstances of each transaction.

Documentation

With our strong and up-to-date knowledge of global regulatory requirements, we have helped our clients meet their global transfer pricing documentation obligations. We migrated clients to different forms of documentation to meet the changing compliance landscape, assisted with Country-by-Country Reporting (CbCR) compliance, Local File and Master File development, as well as regional form submissions.

Audit defense

CRA's transfer pricing consultants successfully defended IP valuations or IP migrations and international tax structures under audit by the IRS and tax authorities around the world. We successfully assisted clients with audits in Australia, China, Denmark, France, Germany, Italy, Puerto Rico, Singapore, the UK, and the US, as well as with state and local tax (SALT) matters.

Litigation consulting

CRA consultants assisted counsel and their clients facing litigation involving tax and transfer pricing disputes. Our 2018 work on high profile cases involved understanding complex industries and complicated issues related to tax reporting, cost sharing, and IP valuations in the US, Canada, and Australia.

A recap of regulations/guidance and litigation

2018 was a significant year for transfer pricing in terms of the regulations and guidance that were issued. CRA maintains an up-to-date reference guide of global TP regulations which is found at http://www.crai.com/service/transfer-pricing/beps-action-13-implementation-and-global-transfer-pricing-documentation.

Regulations – IRS

Certain 2018 IRS TP regulations are presented in the table below.

US – IRS	
January 2018	IRS issued five directives on (i) SBC under CSAs; (ii) RAB shares; (iii) penalties under IRC 6662; (iv) and information data requests in audits; and (v) method selection.
March 2018	IRS released the 2017 Announcement and Report Concerning Advance Pricing Agreements (APA).
June 2018	IRS issued Transfer Pricing Examination Process and Interim Instructions for Sharing with Taxpayers.
August 2018	IRS issued a memorandum on use of multiple RAB shares and subsequent PCTs under a single CSA.

Regulations – OECD

Key OECD projects/TP guidelines issued during 2018 are summarized below.

OECD	
February 2018	OECD and Brazil launched a project to examine differences in cross-border tax rules.
March 2018	OECD released additional guidance on the attribution of profits to a permanent establishment under BEPS Action 7. This additional guidance sets out high-level general principles for the attribution of profits to permanent establishments arising under Article 5(5), in accordance with applicable treaty provisions, and includes examples of a commissionnaire structure for the sale of goods, an online advertising sales structure, and a procurement structure.
June 2018	OECD released revised guidance on the application of the transactional profit split method under BEPS Action 10. The revised guidance retains the premise that the profit split method should be applied when it is considered the most appropriate transfer pricing method and significantly expands the guidance available to help determine when it is. The OECD provided more guidance on how to apply the profit split method by providing numerous examples. OECD released Guidance for Tax Administrations on the Application of the Approach to hard-to-value intangibles (HTVI) – BEPS Actions 8-10. The guidance was issued to reach a common understanding and practice among tax administrations on the application of adjustments when the HTVI approach is used. Guidance includes the principles of when to apply the HTVI approach, examples clarifying such applications, and the interaction between the HTVI approach and the access to the mutual agreement procedure under the applicable tax treaty.
July 2018	OECD released a BEPS discussion draft on the transfer pricing aspects of financial transactions. The discussion draft clarified the application of certain principles included in the 2017 OECD Transfer Pricing Guidelines. The draft provides a delineation analysis of financial transactions and addresses specific issues related to the pricing of financial transactions, e.g., intra-group loans, cash pooling, hedging, guarantees, and captive insurance.
September 2018	OECD released further guidance for tax administrations and multinational enterprise (MNE) groups on CbCR.

Litigation

Transfer pricing litigation in 2018 involved issues such as inclusion of stock-based compensation in cost sharing payments, the degree of comparability needed for the comparable uncontrolled price (CUP) method, and the use of transactional net margin method (TNMM), among other issues. Below we highlight selected cases.

North America

Case	Issue	Status
Canada		
Cameco Corporation (Tax Court of Canada)	The sales of a commodity between related parties allegedly lacked commercial rationale and could not be priced, and therefore, it was argued that the transaction should be re-characterized.	The Court determined the sales of the commodity, which had been approved by a regulator, were appropriate and the pricing of such sales could be benchmarked using CUPs.
USA		
Amazon.com Inc. (US Court of Appeals for the Ninth Circuit Court)	IRS appeal of tax court decision related to a cost sharing agreement that involved Amazon's transfer of IP to a European subsidiary.	The parties have set a date for oral arguments in 2019.
Altera Corporation and Subsidiaries (US Court of Appeals for the Ninth Circuit Court)	The treatment of stock option compensation costs and if such costs should be included in cost sharing agreements.	In July 2018 the Court determined that stock option costs should have been included in CSAs but withdrew its decision in August 2018.
Coca-Cola Company (US Tax Court)	$9.4 billion transfer pricing adjustment related to the licensing of IP to related parties in South America, Europe, and Africa.	Trial concluded and parties have submitted sealed post-trial briefs. Further briefs are due in 2019.
Microsoft Corporation	Microsoft's buy-in payments for transferring intangibles to two of its offshore affiliates pursuant to two different cost sharing agreements.	Microsoft countered by suing the IRS under the Freedom of Information Act to obtain information related to the IRS's use of the outside law firm, Quinn Emanuel Urquhart & Sullivan, in relation to its audit of Microsoft.
Medtronic, Inc. and Consolidated Subsidiaries (US Court of Appeals for the Eighth Circuit)	Whether IP had been transferred to a related party manufacturer for no charge and if the manufacturer should be considered as contract manufacturer for transfer pricing purposes. The IRS proposed the use of the comparable profit method while Medtronic used the CUP method to determine a transfer price.	The Tax Court ruled in favor of Medtronic's use of the CUP method making certain revisions. However, the Appeals Court later vacated the decision determining that further functional and comparability analysis be conducted to determine (i) the best transfer pricing method to be used and (ii) the adjustments needed to improve comparability.

Europe

Case	Issue	Status
EU		
Hornbach-Baumarkt (European Court of Justice)	Whether it was appropriate for no fee to be charged by a parent when providing a financial guarantee.	The ECJ determined that when determining a transfer price, the parent company's status as a shareholder can be considered, and since the subsidiary lacked equity, it was appropriate for the parent company to provide a guarantee for no fee.
Norway		
ExxonMobil Production Norway, Inc. (National Court of Appeals)	The appropriateness of the interest margin on a related party loan.	The NCA determined that the interest payments were not priced at arm's length.
UK		
CJ Wildbird Foods Limited (First-tier Tribunal)	The tax treatment of a loan between the taxpayer and a related entity. HM Revenue & Customs alleged that the loan did not have certain characteristics and therefore, should not be treated as one for tax purposes.	The Tribunal ruled in favor of the taxpayer citing that there was a legal obligation to pay the debt and while the debt had not been repaid, the transaction itself still involved the lending of money.

Asia and Middle East

Case	Issue	Status
India		
Amphenol Interconnect India (Private) Ltd (Bombay High Court)	Whether the resale of goods and sales services could be grouped together for benchmarking analysis and if the transactional net margin method (TNMM) was an appropriate transfer pricing method to use.	The BHC determined that the CUP method could not be used to price the buy/sell transactions and that the functions could be grouped together and benchmarked using the TNMM.
Israel		
Finisar Israel Ltd (Supreme Court)	Whether stock-based compensation should be included in costs when applying the cost plus method.	The SC ruled that stock-based compensation should be included in the costs.
Kontera Technologies Ltd. (Supreme Court)	Whether stock-based compensation should be included in costs when applying the cost plus method.	The SC ruled that stock-based compensation should be included in the costs.

Hot topics in transfer pricing

US tax reform and the impact on transfer pricing

The Tax Cuts and Jobs Act (Tax Act), signed into law in December 2017, affected the tax planning and transfer pricing of multinational enterprises (MNEs) in 2018. The Tax Act addressed activities considered to lead to base erosion of the tax base in the US. Key taxes that potentially impact MNEs when determining their US taxable income are presented in the table below.

Tax	Impacts	Purpose	Tax Rates
BEAT Base Erosion and Anti-Abuse Tax	All MNEs that deduct payments to foreign-related entities and companies that have: • gross receipts of $500 million; and • made "base erosion" payments that are more than 3% of their adjusted deductions for the current tax year.	The BEAT minimum tax was implemented to prevent MNEs from making excessive payments to their foreign-related companies thereby potentially shifting income to lower tax jurisdictions. Payments made by MNEs considered to be "base erosion" payments include intercompany interest payments, royalty payments and payments for services, among others.	• 5% for 2018; • 10% for 2019 through 2025; and • 12.5% for 2026 and after.
GILTI Global Intangible Low-Taxed Income	MNEs with foreign-related entities, specifically targeting US MNEs with foreign-related entities with valuable intellectual property or that are sales and services businesses with limited tangible property.	Similar to BEAT, the GILTI tax aims to limit US base erosion by applying a tax on "excess income" of offshore entities in low-tax jurisdictions. GILTI is a complicated calculation and equates to a foreign-related entity's net income after providing a 10% return on its tangible assets.	• 10.5% for 2018 to 2025; and • 13.125% for 2026 and after.
FDII Foreign-Derived Intangible Income	Company's export income from the sale of goods and services is taxed at a lower rate if such sales uses IP owned by a US company.	To incentivize US companies to maintain their IP in the US.	• 13.125% going forward; and • 16.41% from 2026 and after.

Multinational enterprises must conduct a full assessment of its tax and transfer pricing strategy, and consider the implications of its current intercompany transactions in relation to its exposure to the BEAT, GILTI, and FDII taxes. This unprecedented overhaul of the US tax system is certainly a time for MNEs to take action and assess how to adapt its operations, tax, and transfer pricing strategies to identify and reap the tax advantages that arise from the Tax Act.

The digital economy

As technology companies expand throughout the global economy, tax authorities and the OECD have tried to tackle the complex problem of how to tax them. A fundamental problem has been that the regulations have not been able to keep up with developments in the digital economy and one key issue has been hard to address: where is the value actually created within technology companies?

Developments to date include:

- **OECD:** *BEPS Action 1: Addressing the tax challenges of the digital economy* provided little specific guidance other than asking OECD member states to work to achieve "international coherence in corporate income taxation."
- **EU:** The EU proposal, *Fair Taxation of the Digital Economy*, provides a short-term fix by taxing tech companies 3% on gross revenue from digital services, however this proposal was met with opposition and the EU is expected to refine its proposal.
- **UK:** The UK proposed a tax on the domestic (UK) revenue of digital companies. The UK's tax proposal will come into effect in April 2020 but the UK has asserted that its proposal might be revoked if a global solution is implemented.

- **Australia and New Zealand:** Businesses selling to customers online have to register for goods and services tax (GST).

Achieving consensus on guidance/regulations to tax the digital economy may not be easy in the short term. Legal disputes may define how this issue is resolved. For example, the Wayfair case ruling in the US determined that Wayfair Inc. had established a nexus in South Dakota even though they only operated remotely in the state, and therefore, was now subject to GST. Similarly, in India, a court ruled that MasterCard Singapore's remote operations in India constituted a permanent establishment. With such rulings, companies may indeed need to assess whether their operations in certain jurisdictions could be viewed as nexus/permanent establishment and the impact of that on their transfer pricing, until tax authorities and/or the OECD develop concrete rules and/or guidance.

What lies ahead in 2019

In a post-BEPS era and with a changing geopolitical environment that resulted in US tax reform and tariffs and trade wars, 2019 will be a significant year in transfer pricing. Issues to watch include:

- **US tax reform:** The interplay of BEAT, GILTI, and FDII in determining the company's global tax position, is not just a computation issue. It also raises a significant question of whether a company should restructure its global operations. For example, as companies determine if the BEAT applies to them and specifically, determine which intercompany transactions involve tangible versus intangible assets, companies might want to revisit their operating models, particularly if their R&D activities are not in the US. Any changes to a company's operating model should also consider how its transfer pricing would be affected by any such changes. A company's assessment of the impact of US tax reform on its operations cannot be done in isolation and must include a review and assessment of its transfer pricing.
- **Recent transfer pricing cases:** Transfer pricing court decisions set the "new case standards" in transfer pricing. Companies should check if they meet such standards. As our 2018 review of transfer pricing litigation indicates, MNEs should keep an eye on certain issues.
    - Companies should check that the interest rates on their intercompany loans are supported by substantial analysis and documentation.
    - Companies should know how stock option compensation costs are treated in their current cost sharing arrangements and follow future case rulings on the matter.
    - Companies should be aware of the courts' preference for the CUP method (even with adjustments) over other transfer pricing methods in certain situations.
    - Companies should check the locations of their remote operations to see if they could be deemed as a permanent establishment and understand the implications of such a determination.

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