Analysis of Intellectual Property Tax Planning Strategies of Multinationals and the Impact of the BEPS Project

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Introduction

- The global economy and the international tax profile of MNEs are receiving unprecedented levels of attention by governments, media and non-governmental organisations.

- The recent European Commission's ("EC") preliminary decisions revising taxation of billions of US dollars from well-known MNEs once again drew attention to tax strategies used by MNEs to shift profits from high tax jurisdictions to zero or low tax jurisdictions.

Introduction

- MNEs tend to use complicated group structures linked to market issues, artificial and complex methods to shift profits across countries and one of the most commonly used technique is distorting prices of related party transactions.

- Transition to globalised operating models, increased importance and perceived portability of intangibles has resulted in relocation of intangible property (IP) between related parties, without transferring the assets or people.

Introduction

Profit-diverting activities such as deferral of taxation until income is remitted (repatriated) by subsidiaries to the parent company generate great profit for MNEs.

The recent changes to Base Erosion and Profit Shifting ("BEPS") tax planning strategies demonstrate that there is general awareness of this issue and lawmakers are turning their mind to the fact that MNEs are using complex group structures and arrangements to shift profits out of a high tax jurisdiction and into a lower tax jurisdiction.

Research Objectives

- To analysis the effectiveness of the existing framework in which MNE group (different entities) adjust or defer their tax liability through complicated arrangements which focus on the use of IP and exploiting differences in countries' laws and regulations.

- Proposed impact of OECD's BEPS Action Plan and its willingness to ensure pricing reflects the economic substance as opposed to the legal form of arrangements.

Research Method

The current study had adopted a case study method.

The term "case" in the current study refers to practical examples (scenarios) of the complex group structures adopted from the selected MNEs, to evaluate OECD proposed amendments.

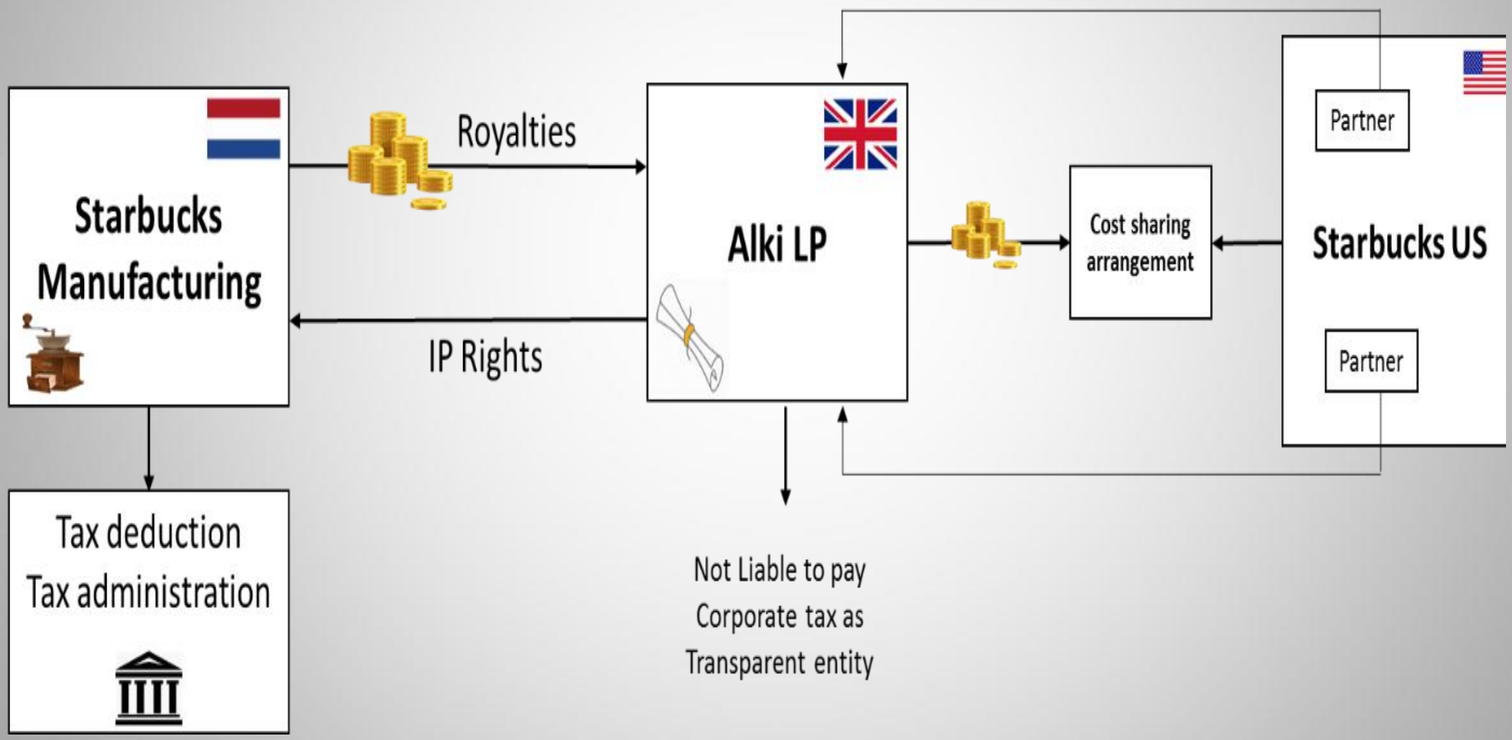
Purposive sampling approach has been undertaken.

Emphasis is not on the number of cases selected but on why these were selected and what they represent.

Identification of Sample

- The current study focus was on complex multinational corporations with wide nets of affiliates, which are under investigation regarding the issue of complex group structure and right to use of intangibles (royalties), leading to tax minimisation/deferral.
- Bloomberg database was scanned. Priority was given to investigations that had taken place within the defined research period, year 2013 to 2016.
- The European Commission's official website was used to retrieve press releases and published open decisions.
- Three key cases *Amazon, McDonald's* and *Starbucks* were the context for this study.

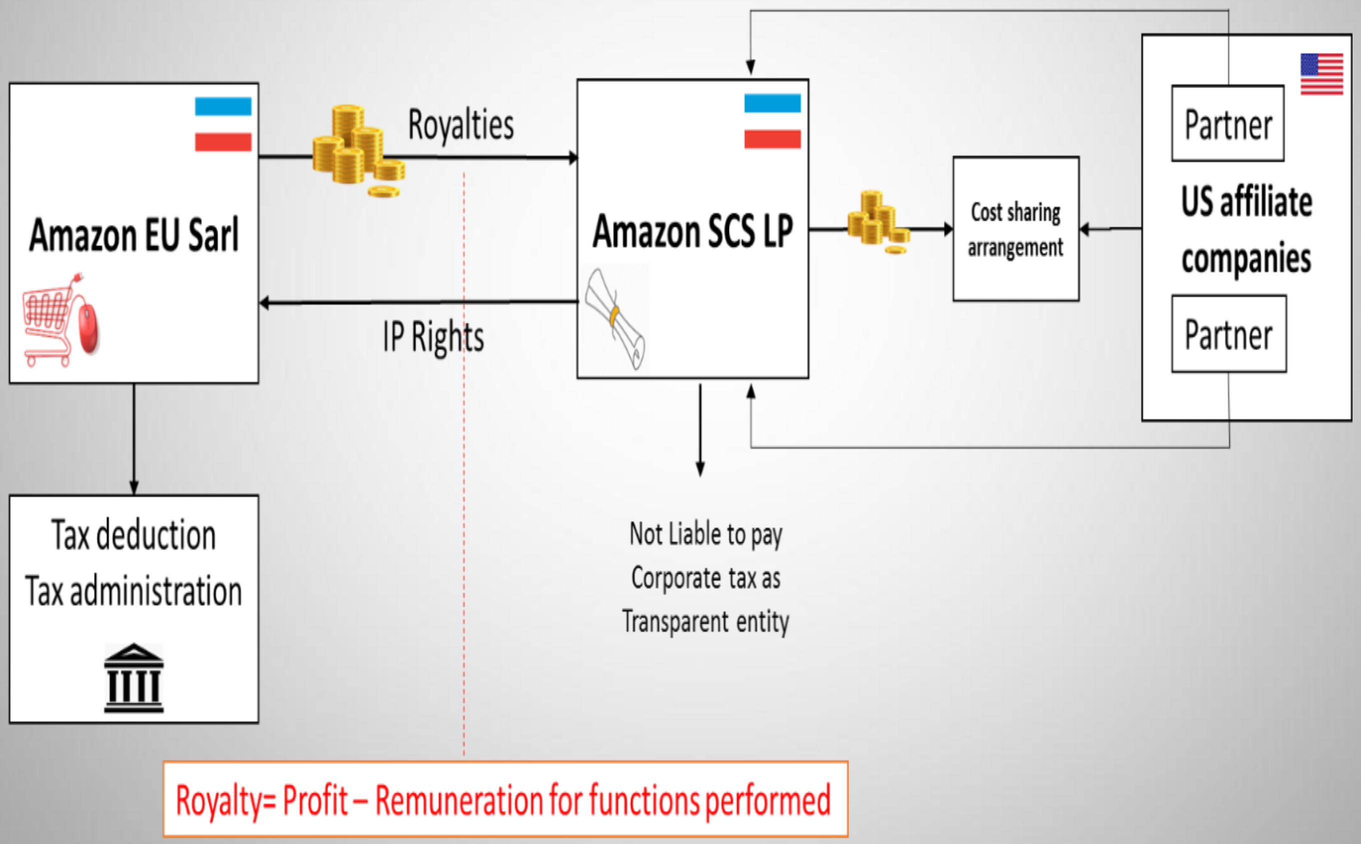
Starbucks


Royalties
Starbucks Manufacturing
IP Rights
Alki LP
Cost sharing arrangement
Partner
Starbucks US
Partner
Tax deduction
Tax administration
Not Liable to pay
Corporate tax as
Transparent entity

Starbucks Scheme

- Starbucks reduced its tax by the way of shifting income in the form of royalty payments between related entities, which were established in different tax jurisdictions.
- By setting up Starbucks Manufacturing in the Netherlands, Starbucks has taken advantages of the Dutch tax rules to avoid taxation of royalty payments.
- Presence in the UK in the form of limited partnership also allowed it avoid tax liability under UK tax legislation.
- Earnings were not repatriated back to the US.

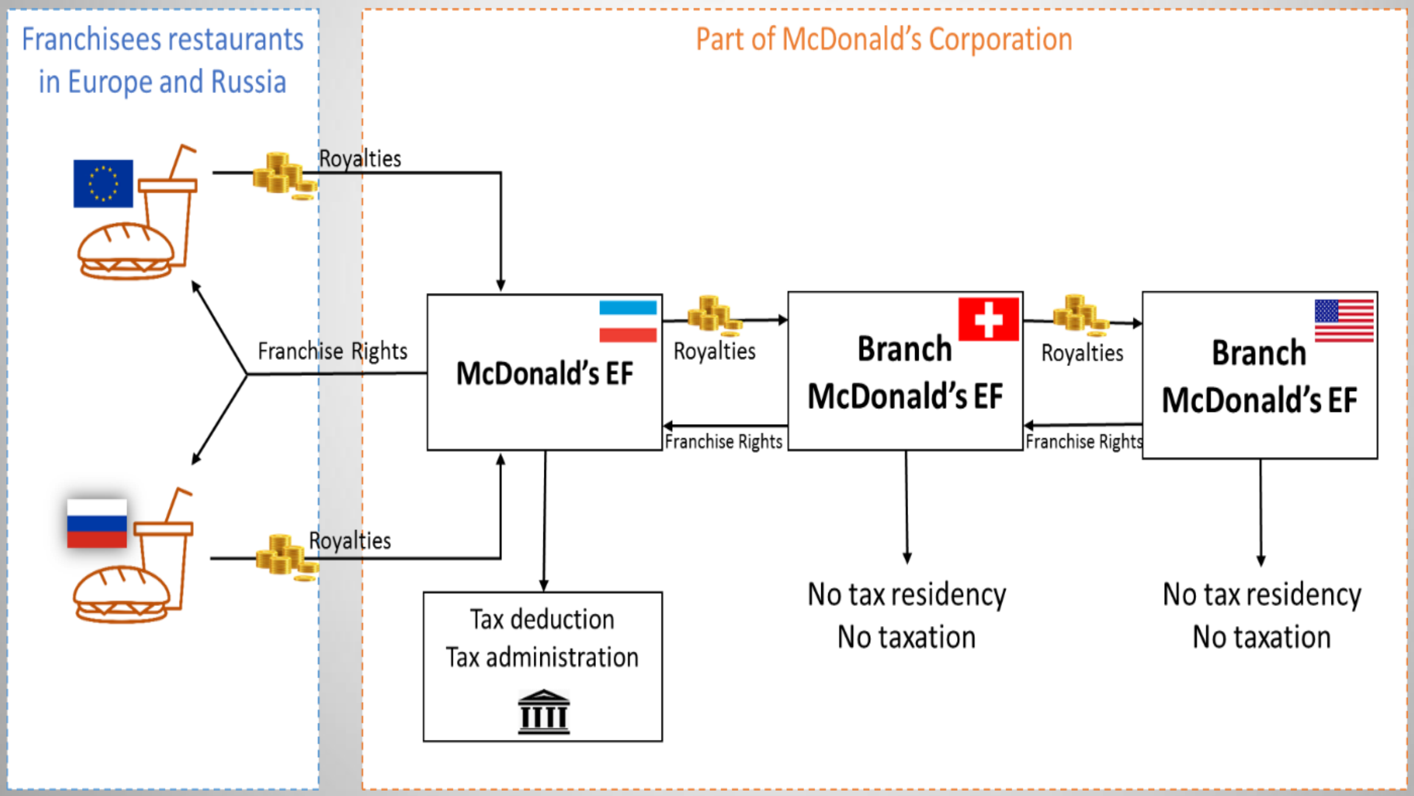
Amazon Scheme



Amazon Scheme

- Amazon SCS (Luxembourg) LLP licenses the IP rights to Amazon EU (Luxembourg) in return for a tax deductible royalty.
- Under the Luxembourg tax rules royalty payments are tax deductible and not subject of any withholding tax to local or foreign recipients.
- The case has not been concluded yet.

McDonald's Scheme



McDonald’s Scheme

- McDonald’s franchisees restaurants in Europe and Russia have paid royalties to McDonald’s EF itself or through its branch in Switzerland, after that, the royalty received is transferred to the US branch.
- Luxembourg tax authorities assume that the US branch and Swiss branch constitute permanent establishment in the US and Switzerland respectively, therefore, their profits are taxable in respective countries.
- US tax authorities- the US branch does not undertake adequate trade or business activities, so it does not have a taxable presence in the US.

Tax Planning/Tax Avoidance

- In all the three cases the tax authorities accepted the transfer-pricing policies suggested by the company's tax advisors and the method of transfer pricing used was not an issue.

- The analysis shows that the tax authorities did not use an objective basis to determine the effect of the complex group structure on the royalties transfer pricing policies adopted by MNEs.

DEMPE Functions

- BEPS Actions 8-10 Guidance

Entitlement to right of return from intellectual property depends on functions, assets and risks and return will be assigned to the entities that perform and control the five key value-creating functions of developing, enhancing the value, maintaining (modification, quality control), protection against infringement and exploiting the intangibles (referred to as the “DEMPE” functions).

- A 6-step approach for transfer pricing analysis of intangibles provides the elements, to identify appropriately commercial and financial relationships .

DEMPE Approach

- Identification of the intangibles used or transferred.
- Identification and evaluation of full contractual arrangements to determine legal ownership of intangibles.
- Functional analysis of the DEMPE functions to understand the contribution of each party.
- Evaluate that the terms of the contractual arrangements are consistent with the conduct of the parties.
- To delineate the actual controlled transactions related to the DEMPE functions and risks.
- To determine arm’s length prices for similar contributions.

DEMPE Approach

- There is a clear shift in focus from the legal form to the economic reality of a transaction and transfer pricing outcomes have been aligned with economic substance.
- Where a legal owner is not performing and controlling all the five DEMPE functions, the owner would not be entitled to collect all returns derived from the exploitation of such an intangible.
- The capital-rich companies which fund risk-taking opportunities, legal owners but have no functional input are entitled to investment return only and the entity exercising control has the right to collect the risk premium.

DEMPE Approach

- Changes encourage groups to combine intangibles ownership, decision-making, control and development activity in the same legal entity.

- DEMPE functions are not defined which can lead to interpretation inconsistency and is likely to create a great deal of confusion and uncertainty as different practitioners and tax administrations interpret it differently.

Conclusion and Limitations

- The tax authorities did not have a strong approach while evaluating the documents furnished by the MNEs, thereby, not identifying absence of significant details and the full contractual arrangements.

- The DEMPE approach aims to identify actual relationships between associated parties and their contribution to conclude whether the entity is entitled to return.

Conclusion and Limitations

- Besides the royalty payments there may be other issues, for instance, problems related to the choice of an inappropriate method to approximate an arm's length pricing of transactions, or permanent establishment and treaty issues.

- No recent examples with the application of the DEMPE approach are available and a reputable body such as the Commission or the court have not commented on the approach.

Recommendation

- An "economic substance" test would be uncertain and difficult to administer and the test needs to be clearer and more tightly defined.
- To address the increasing risk of tax controversy, adjustments and penalties MNEs need to exercise considerable objectivity and caution while putting in place IP remuneration structures and ensure that they do not deviate from principles of risk-return that have been clearly laid down by the OECD in its final report.

Questions