WTS Transfer Pricing Seminar

by WTS Taxise Singapore

22 January 2020

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Agenda

» Overview on transfer pricing
» Transfer pricing risk management
» Break
» Operational TP
» Digital Tax and Digitalization – the Future of TP

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WTS Taxise (Singapore)

8 Shenton way, #36-03, AXA Tower,
Singapore 068811, Singapore

Phone: + 65 9234 4608
Email: sam.sim@taxiseasia.com

Sam Sim

Co-founder, WTS Taxise
Member of International Association of Tax Judges
Asia-Pacific Transfer Pricing Leader

Education

- New York University School of Law (LL.M. Tax), admitted New York attorney-at-law
- Cambridge University (B.A., M.A. Economics)
- Singapore Management University (Master in Professional Accounting), CPA
- National University of Singapore (LL.B.), admitted advocate & solicitor of the Supreme Court of Singapore

Professional Background

- Member, Income Tax Board of Review
- Senior Advisor, Vienna University, Global Tax Policy Center
- Research Fellow, SMU Center for Artificial Intelligence & data governance
- Member, UK Chartered Institute of Taxation, ADIT committee
- IBM, Geo-leader, Europe, Middle East, Africa, Asia-Pacific, Greater China & Japan
- Standard Chartered Bank, Deputy global head, Transfer pricing
- Board member, Tax Analyst, USA
- Tax Executive Institute, Regional VP for EMEA, AP and Latin America

Specialization

- Complex supply chain and IP planning including cost sharing, high tech incentives
- Controversy – Complex audits, Competent authority, APA, MAP, litigation
- Digital tax issues across hardware, software, services, Cloud, AI, Blockchain
- Financial Services including global trading, investment banking, funds, Fintec
- Operational TP

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James Yeo

Transfer Pricing Manager

WTS Taxise (Singapore)

8 Shenton way, #36-03, AXA Tower,
Singapore 068811, Singapore

Phone: + 65 9128 3087
Email: james.yeo@taxiseasia.com

Education

» Singapore Management University (Bachelor of Accountancy)
» CFA Institute (Chartered Financial Analyst)
» Insititute of Singapore Chartered Accountants (Chartered Accountant of Singapore)

Professional Background

» Ernst & Young (EY) across the Singapore, London and Sydney practices

Specialization

» Global and regional transfer pricing planning and documentation
» Transfer pricing design, structuring and operating model effectiveness
» Transfer pricing controversies, including audit defense, APA and MAP
» Financial services industries, including banking and capital markets, insurance and wealth and asset management
» Experienced in commodities, consumer and industrial products, electronics, global logistics, healthcare, resources, technology sectors, amongst others

Overview of transfer pricing

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1. Transfer Pricing Primer

HQ Co.

Country A

Country B

A Sub Manufacture Co

Widgets

B Sub Distribution Co

3rd party customers

Functions – manufacture
Assets – IP/know-how, factory, brand
Risks – inventory, warranty, credit risks

Functions – marketing
Assets – limited
Risks – limited

100,000

Sales	**100,000**
COGS	**(60,000)**
Other Exp	**(25,000)**
Profit	**15,000**
Tax (@ 30%)	**4,500**

Sales	**140,000**
COGS	**(100,000)**
Other Exp	**(35,000)**
Profit	**5,000**
Tax (@ 15%)	**750**

2. Alternative Transfer Price

HQ Co.

Country A

A Sub Manufacture Co

Widgets

Country B

B Sub Distribution Co

90,000

Sales	**90,000**
COGS	**(60,000)**
Other Exp	**(25,000)**
Profit	**5,000**
Tax (@ 30%)	**1,500**

Sales	**140,000**
COGS	**(90,000)**
Other Exp	**(35,000)**
Profit	**15,000**
Tax (@ 15%)	**2,250**

3. TP Impacts Relative Taxing Rights of Two Countries

MNE Group Tax Burden

Split of Tax

Transfer Price #1

Transfer price = 100,000

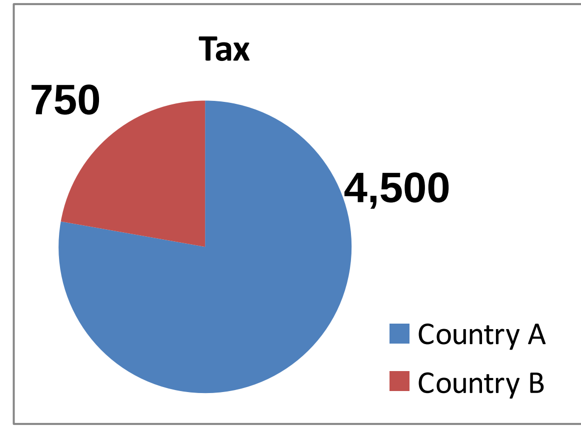
Manufacture Co

Profit = 15,000
Tax = 4,500

Distribution Co

Profit = 5,000
Tax = 750

5,250



Profit of $10,000 shifted from high to low tax country saves MNC $1,500 of taxes

Transfer Price #2

Transfer price = 90,000

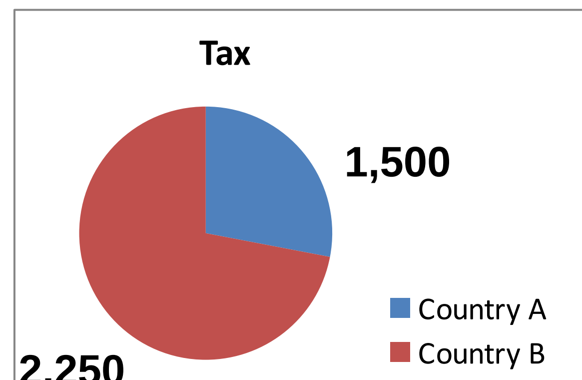
Manufacture Co

Profit = 5,000
Tax = 1,500

Distribution Co

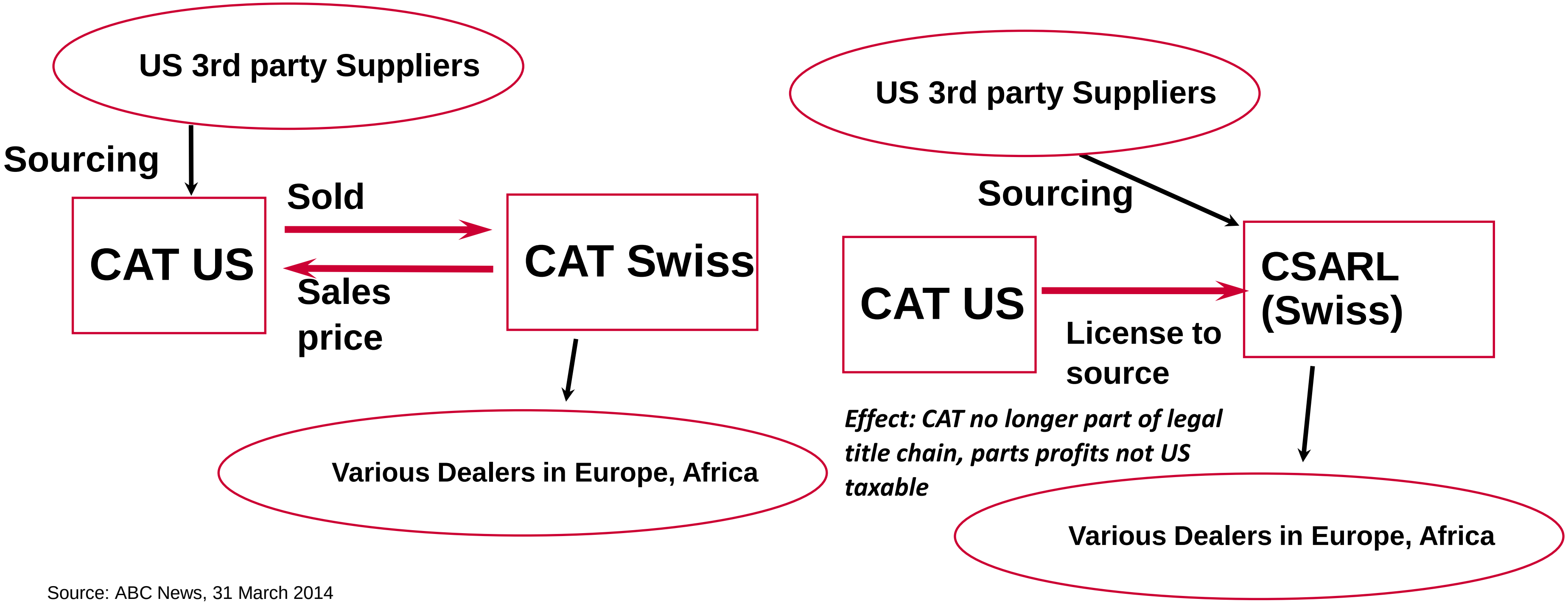
Profit = 15,000
Tax = 2,250

3,750



Caterpillar

- Purportedly shifted $8 bn in profits from its parts manufacturing division in the U.S. to Switzerland. Caterpillar negotiated a tax rate of 4% to 6% with Switzerland, whose federal statutory tax rate is typically 8.5 %.
- 85% of profits from replacement parts division shifted to a related Swiss affiliate, while 15% of the profits remained in the US, where 70 percent of the company's third party manufactured parts that are sold abroad are manufactured, stored and shipped.



Source: ABC News, 31 March 2014
(HTTPS://REGISTER.GO.COM/GLOBAL/LOGIN?APPREDIRECT=HTTP%3A%2F%2FABCNEWS.GO.COM%2FBLOGS%2FPOLITICS%2F2014%2F03%2FCATERPILLAR-INCAVOIDED-
2-4-BILLION-IN-U-S-TAXES-SENATE-REPORT-SAYS%2F)

- The 2014 Senate investigation report said that Caterpillar worked with PWC to use **sham transactions** to transfer $8 billion in profits to a Swiss subsidiary from **1999 to 2012**.
- **The transfers were not legitimate business transactions, but were made solely to take advantage of a lower tax rate Caterpillar had negotiated with Switzerland**, said Senator Carl M. Levin.

Caterpillar Inc., 10-K, 2/17/15

On January 30, 2015, we received a Revenue Agent's Report (RAR) from the Internal Revenue Service (IRS) indicating the end of the field examination of our U.S. tax returns for 2007 to 2009 including the impact of a loss carryback to 2005. The RAR proposed tax increases and penalties for these years of approximately $1 billion primarily related to two significant areas that we intend to vigorously contest through the IRS Appeals process. In the first area, the IRS has proposed to tax in the United States profits earned from certain parts transactions by one of our non-U.S. subsidiaries, Caterpillar SARL (CSARL), based on the IRS examination team's application of the “substance-over-form” or “assignment-of-income” judicial doctrines. We believe that the relevant transactions complied with applicable tax laws and did not violate judicial doctrines. We have filed U.S. tax returns on this same basis for years after 2009. In the second area, the IRS disallowed approximately $125 million of foreign tax credits that arose as a result of certain financings unrelated to CSARL. Based on the information currently available, we do not anticipate a significant increase or decrease to our recognized tax benefits for these matters within the next 12 months. We currently believe the ultimate disposition of these matters will not have a material adverse effect on our consolidated financial position, liquidity or results of operations. We expect the IRS field examination of our U.S. tax returns for 2010 to 2012 to begin in 2015. In our major non-U.S. jurisdictions, tax years are typically subject to examination for three to eight years.

Caterpillar Defending Suits Over Swiss Tax 'Scheme'

March 29, 2016 — Equipment manufacturer Caterpillar Inc. and its audit firm, PricewaterhouseCoopers LLP, face investor suits over a "discredited tax evasion scheme" that has prompted government investigations and possible penalties.

According to complaints filed March 28 and Feb. 22 in Delaware Chancery Court, shareholders alleged that Caterpillar management exposed the company to billions of dollars in liabilities by signing off on a plan developed by PwC to unlawfully avoid $2.4 billion in U.S. taxes by shifting profits to a subsidiary in Switzerland (Mogell v. Oberhelman, Del. Ch., No. 12143, complaint filed 3/28/16; Pill v. Oberhelman, Del. Ch., No. 12027, complaint filed 2/22/16).

Shareholders Judy Pill and Rosalie Mogel, who are represented by the Wilmington, Del., firm Rosenthal, Monhait & Goddess PA, said directors and officers of Caterpillar, aided by the audit firm, breached their fiduciary duties, damaging the company's reputation and passing misleading information to stockholders. Representatives from Caterpillar and PwC couldn't be immediately reached for comment March 29.

Government Probes

The Securities and Exchange Commission has closed an inquiry into the matter, but a grand jury probe by the U.S. Attorney for the Central District of Illinois continues. The Peoria, Ill.-based company also continues to face scrutiny by the Internal Revenue Service, which may seek tax increases and penalties of $1 billion from Caterpillar for the 2008-2009 tax years (24 Transfer Pricing Report 1247, 2/18/16)

Source: Che Odom, BNA Bloomberg, 24 Transfer Pricing Report 1470

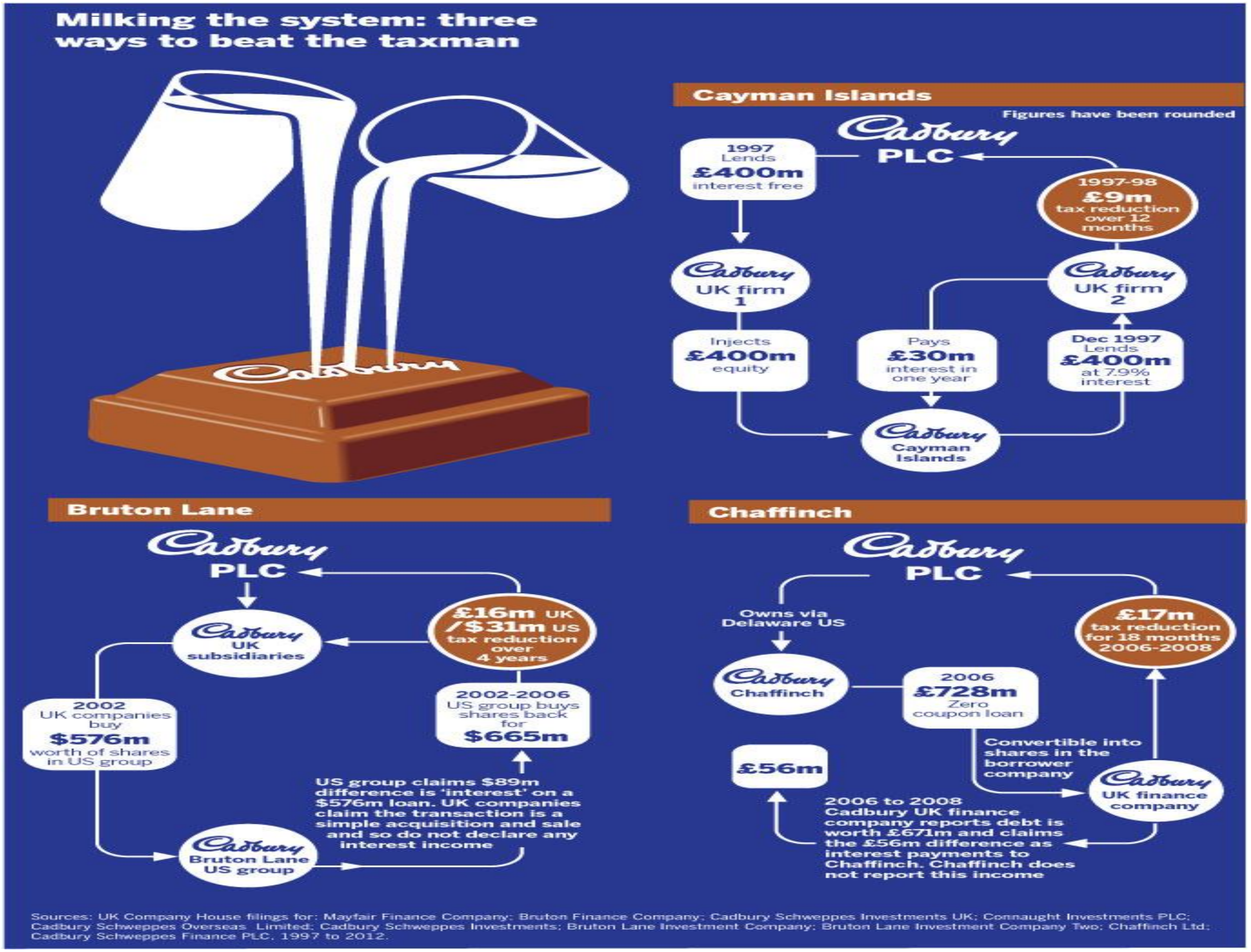
Caterpillar - The Raid

» In an escalation of an inquiry into Caterpillar's offshore tax practices, 3 of its buildings near its headquarters were raided.

» **Caterpillar's stock dropped 4.2 percent on the day of the raid.**

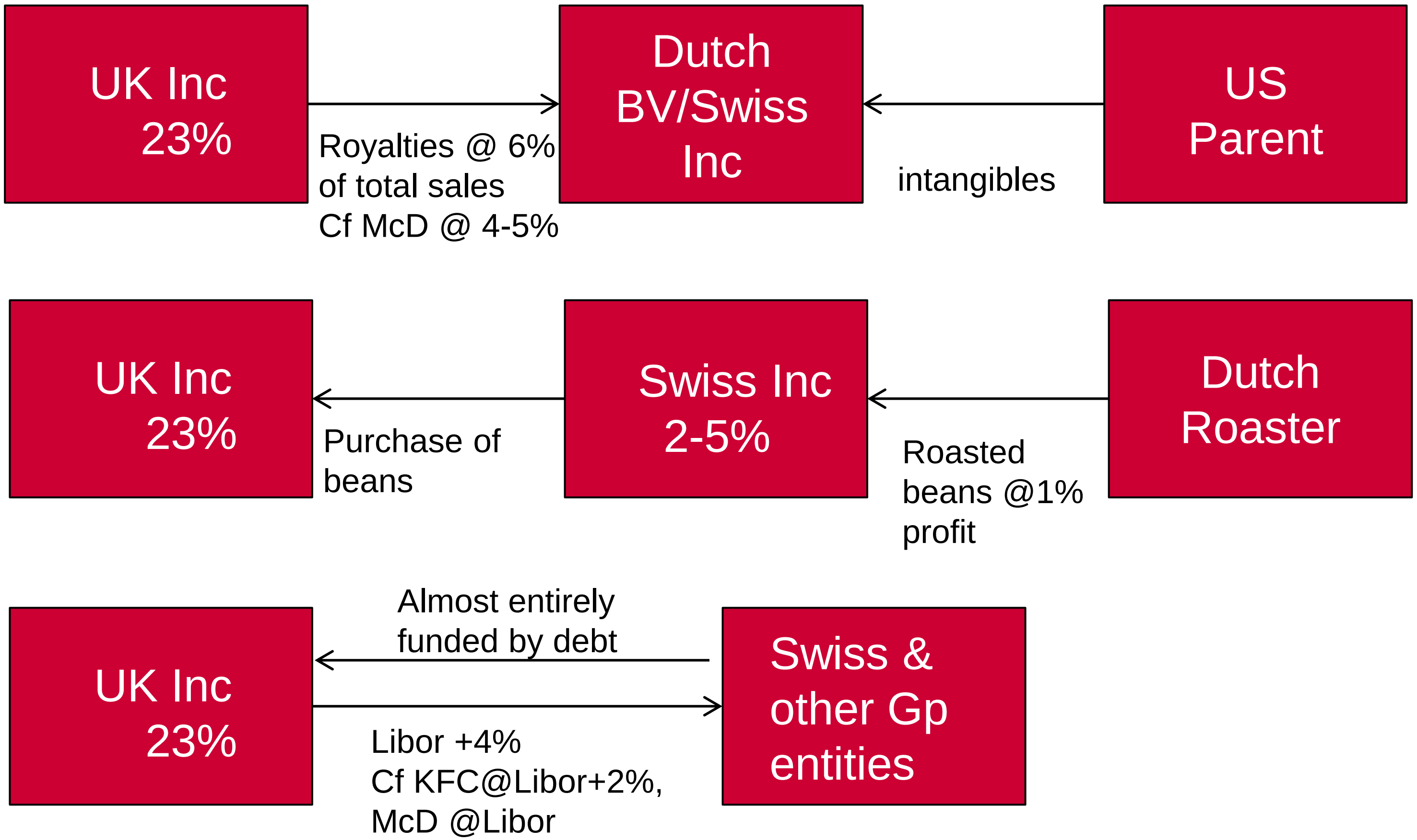
https://www.nytimes.com/2017/03/02/business/caterpillar-raid-tax-practices.html

Case Study Intra-Group Financing



Brewing Up Profits

Base Erosion and Profit Shifting Report – Starbucks Case Study



This example is not factual and is purely illustrative as adapted from a Reuters article “ Special Report: How Starbucks avoids UK taxes” on Mon, Oct 15 2012 by Tom Bergin

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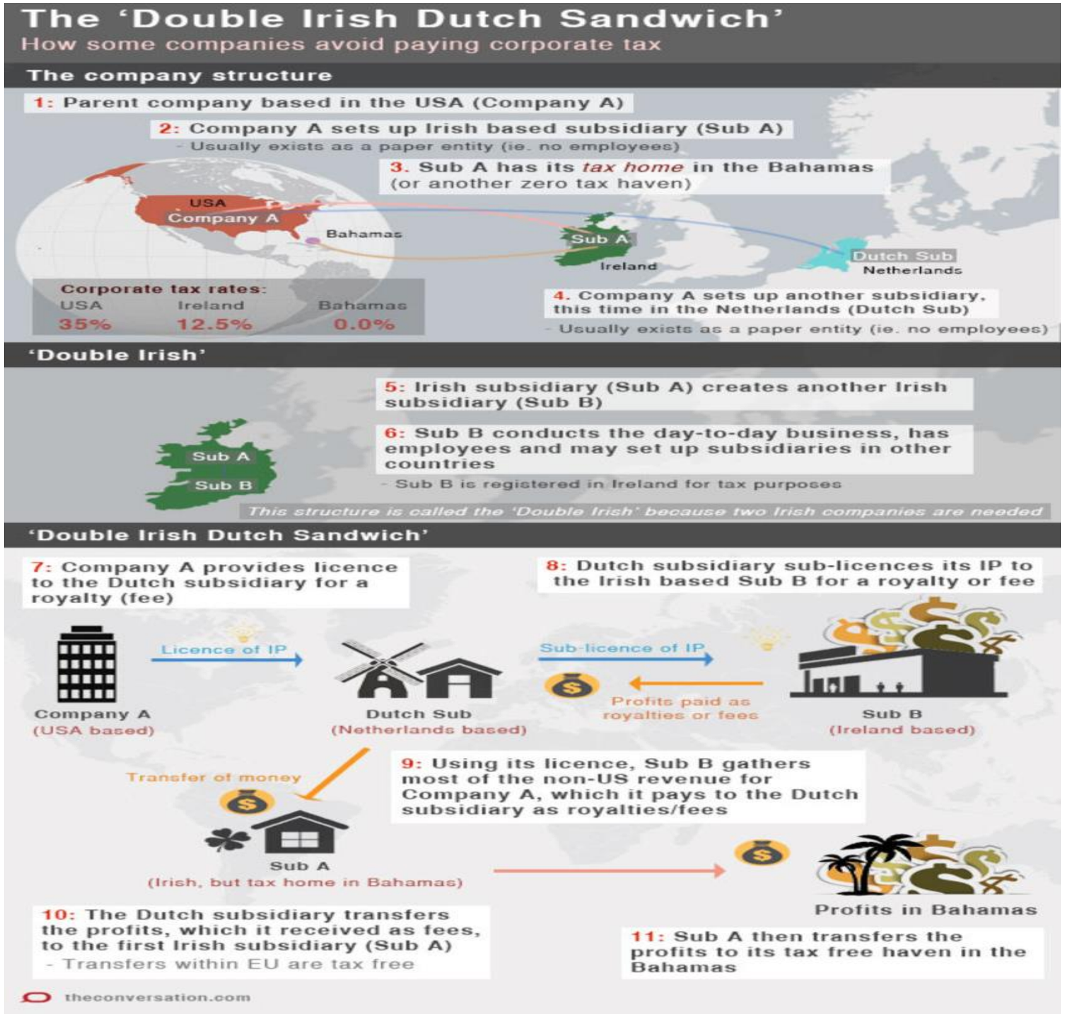
Double Irish Dutch Sandwich



OECD Transfer Pricing Guidelines

OECD Transfer Pricing Guidelines ("TPG") for Multinational Enterprises and Tax Administrators is key guidance document on transfer pricing.

- Principles and key concepts in the OECD TPG includes:
  - Definition of related party
  - The arm's length principle
  - The five TP methods and comparability factors
  - TP documentation
  - Transaction specific approaches (e.g. services, intangibles)
- The "arm's length principle" represents the international consensus on the valuation, for income tax purposes, of cross-border transactions between associated enterprises.
- The OECD TPG was last updated in 2017 and since then there has been further revisions and discussion drafts across various topics conducted by the OECD (e.g. hard-to-value intangibles, application of transactional profit split method, discussion draft on financial transactions, Pillar 1 and 2 etc).

TP – More Than Just A Tax Risk

- ***2013 Shift to risk management: 66% of companies identified "risk management" as their highest priority , a 32% increase over 2010. Only 17% identify cash tax or effective tax rate optimization as their highest priority, a 1/3 fall from 2010.***
  - ***2017 Tax Risk survey – TP is biggest source of tax risk***
  - ***2016-2017 Global TP survey – 79% believe dispute resolution is becoming > difficult***

1995	1996-2000	2001-2002	2003-2004	2005-2006	2007-2009	2009- Present
						Philippines
						HK
					Indonesia	Indonesia
				Singapore	Singapore	Singapore
				Vietnam	Vietnam	Vietnam
			Taiwan	Taiwan	Taiwan	Taiwan
			Malaysia	Malaysia	Malaysia	Malaysia
		Thailand	Thailand	Thailand	Thailand	Thailand
		India	India	India	India	India
	China	China	China	China	China	China
	Japan	Japan	Japan	Japan	Japan	Japan
	New Zealand	New Zealand	New Zealand	New Zealand	New Zealand	New Zealand
	Korea	Korea	Korea	Korea	Korea	Korea
Australia	Australia	Australia	Australia	Australia	Australia	Australia

TP on the Frontpage

- Global Action Against MNC Tax Avoidance: Base Erosion and Profit Shifting report, Action Plan
- Reputational Risk: UK Parliamentary hearing, Google, Starbucks

Media Attention

“[Apple’s] Tim Cook is scheduled to testify before Congress…Known as ‘transfer pricing,’ these moves are frequently managed to reduce corporations’ global tax costs.”

Huffington Post , 20 May 2013

“Google’s Northern Europe boss, Matt Brittin, was called back to testify to parliament… Brittin said the company was already being investigated by the UK tax authority in relation to transfer pricing”

Reuters, 16 May 2013

“…Starbucks has avoided paying [corporation tax] for three years in the UK through complex international payments within the company known as transfer pricing.”

The Guardian, 6 December 2012

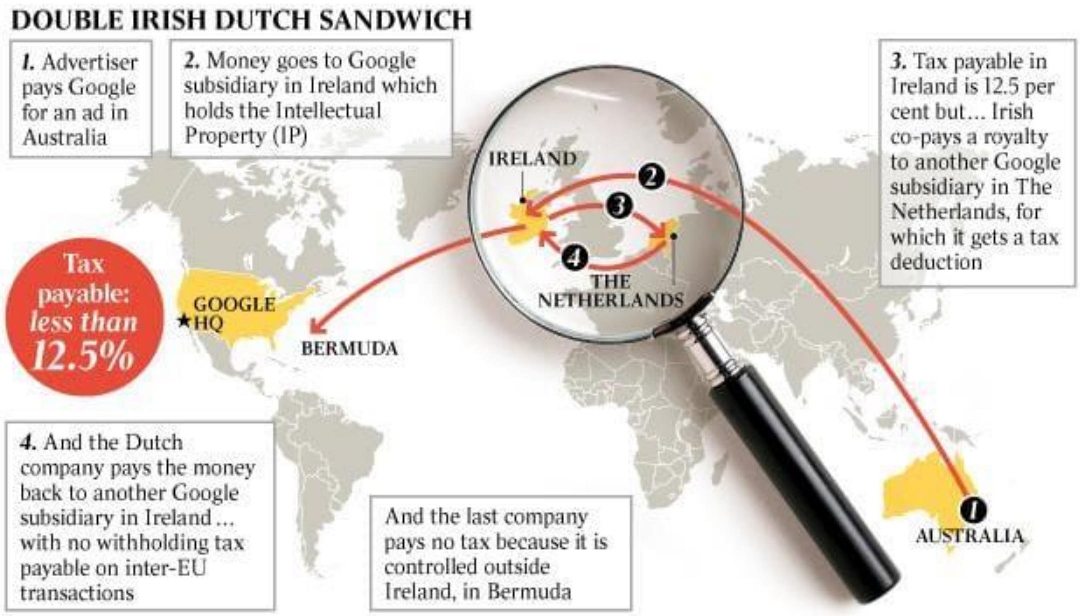
“…higher price than it paid for the right to license Amazon intellectual property could open [Amazon] to an investigation into whether it is engaging in abusive transfer pricing.”

Reuters, 6 December 2012

“A March 2015 Bloomberg News analysis of the securities filings by U.S. multinational companies revealed that approximately $2.1 trillion of their profits are held offshore under the “indefinitely reinvested exception.”

“Recent (2015) estimates suggest around €70bn a year is lost through tax avoidance – revenue that could be used to help maintain infrastructure, including schools, transport systems, healthcare, etc. Instead, it slips through the net.”

BEPS



Source: The Mail online and The Daily Mail.
http://www.google.com.sg/imgres?biw=1280&bih=822&tbm=isch&tbnid=zm3LUk9rvWf2MM:&imgrefurl=http://www.theglobalmail.org/feature/google-dont-be-evil-dont-pay-
https://www.google.com.sg/search?q=google+double+irish+dutch+sandwich&biw=1366&bih=643&tbm=isch&tbo=u

OECD Base Erosion and Profit Shifting (BEPS) project

Coherence

Harmful or inappropriate use of international tax legislation to obtain unintended tax benefits

Action 2
Hybrid mismatch arrangements

Action 3
Controlled foreign corporation (CFC) rules

Action 4
Interest deductions and other financial payments

Action 5
Harmful tax practices

Substance

Mismatches where profits are being taxed versus where people responsible for generating these profits are located

Action 6
Preventing tax treaty abuse

Action 7
Artificial avoidance of permanent establishment (PE) status

Action 8
TP aspects of intangibles

Action 9
TP aspects of risk and capital

Action 10
TP aspects of high-risk transactions

Transparency

Provide tax authorities information to carry out audits better and determine if “fair share” of taxes are being paid

Action 11
Methodologies and data analysis

Action 12
Disclosure rules

Action 13
TP documentation and Country-by-Country Reporting (CbCR)

Action 14
Dispute resolution

Action 15 Multilateral instrument

Action 1
Digital economy

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Overview of Actions 8-10 – Aligning transfer pricing outcomes with value creation

Action 8: Intangibles	Action 9: Risk and Capital	Action 10: Other high-value transactions
» Wider and clearer definition of “intangibles” » Introduction of a six-step framework to analyze TP aspects of intangibles » Routine attribution of profit to legal ownership » Focus on Development, Enhancement, Maintenance, Protection and Exploitation (DEMPE) functions » Guidance for Hard-to-value Intangibles (HTVI) and Cost Contribution Arrangements (CCA)	» Focus on conduct of parties and their capability and functionality to manage risks » Assumption of risk without “control” over that risk is likely to be problematic » Routine return to pure economic funding without underlying functionality » Introduction of a six step framework to analyze risks for TP purposes	» Safe harbor for low value-add services (LVAS) » Guidance for Profit splits » Preference for CUP for Commodity transactions

Overview of Actions 13 – Three-tiered approach to transfer pricing documentation

Master file

Broad information about the multinational corporation's (MNC) business, TP policies and agreements with tax authorities in a single document available to all tax authorities where the MNC has operations

Local file

Detailed information about the local business including related party payments and receipts for products, services, royalties and interest etc.

Country by Country Reporting (CbCR)

Broad information about the jurisdictional allocation of profits, revenues, employees and assets

Note: Additional analysis/information may be required to meet specific local country transfer pricing documentation requirements

Conceptual framework

» Related party definition
» Arm's length principle
» Value creation
» Entity characterization
» TP methods
» TP documentation

Related party definition

Related party definition

Under OECD TPG, the definition of associated enterprises is referred to Article 9 of the OECD Model Tax convention, i.e.,:

- a) An enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or
- b) The same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other.
- Different countries may have different definitions of “related party” based on their respective income tax regulations and typically also revolve around control from a shareholding, management, directorship, debt perspective. Countries may define percentage of ownerships (e.g. more than 25% of issued stock (China/Indonesia) / more than 50% of issued stock (Japan)).
- A starting point could be the related party disclosures reflected within the audited financial statements.

Examples of intercompany transactions

- Tangible goods
  - Sale of finished products from manufacturer to distributor/retailer
  - Sale of raw materials or semi-finished products from procurement company to manufacturer
- Services
  - Provision of routine services (e.g. OECD low value-adding services)
  - Provision of non-routine services (e.g. strategic management, IT development, R&D)
- Intangible assets
  - Sale/License of trademark or patents
  - Sale/License of business process or software
- Financial or other transactions
  - Loan, guarantees, factoring
  - Cash pooling arrangements

Arm’s length principle

Arm’s length principle

OECD TPG – Arm's Length Principle (ALP) in Article 9 of the OECD Model Tax Convention

- [Where] conditions are made or imposed between the two [associated] enterprises in their commercial or financial relations
- which differ from those which would have been made between independent enterprises, then
- any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued,
- may be included in the profits of that enterprise and taxed accordingly

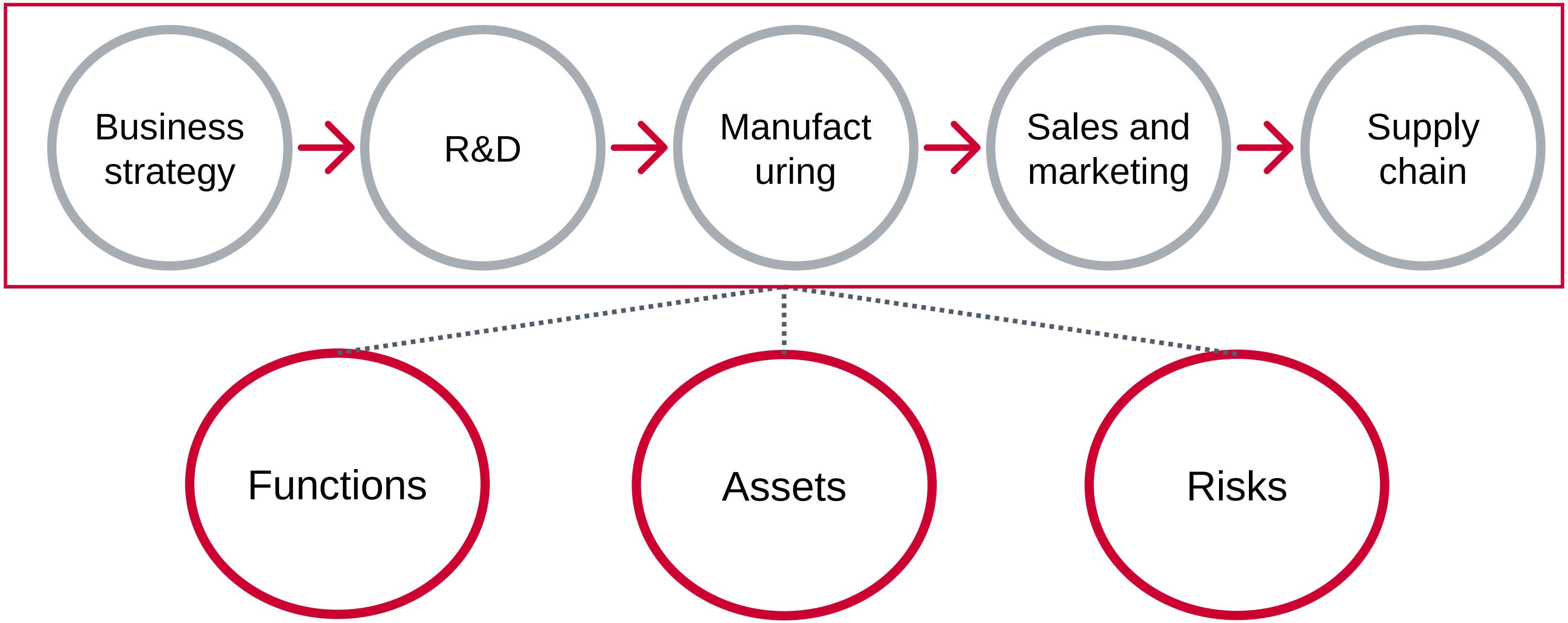
Arm's length principle (con't)

- An intercompany transaction is at arm's length if the results are the same as results realized by uncontrolled taxpayers engaged in the same transaction under the same circumstances.
- When identical uncontrolled transactions are not available, it is appropriate to consider other comparable uncontrolled transactions.
- Analysis of independent, uncontrolled comparable transactions is at the center of all TP analysis.
- OECD member countries consider that an appropriate adjustment is achieved by "establishing the conditions of the commercial and financial relations that they would expect to find between independent enterprises in similar transactions under similar circumstances."
- Increasingly, revenue authorities also expect to see arm's length "circumstances" between related parties – whether transactions are entered into under circumstances that unrelated parties would willing enter into (e.g. arm's length debt test).

Value creation and entity characterization

Value creation

How key value chain processes are managed



Contributors to value chain profits

A TP analysis should take into consideration the business unique value chain processes and its key value drivers

Value creation (con't)

- TP regulations generally assume that value creation and therefore, expected returns, are positively and causally related to extent of functions performed, assets owned and risks assumed by a given entity.
  - More complex/high value functions ➔ higher expected return
  - More assets owned ➔ higher expected return
  - Intangible assets owned ➔ higher expected return
  - More risks managed and assumed ➔ higher expected return

- The OECD has reiterated its adherence to the arm's length principle by clarifying that profits should be taxed where the real economic activities generating the profits are performed and where value is created in accordance with BEPS Actions 8-10 (Aligning transfer pricing outcomes with value creation).

Value creation (con’t)

- Other relevant factors for considerations include:
  - Geographic differences (location-specific costs, location savings)
  - Level of markets (wholesale, retail)
  - Market conditions (stable, expansion or contraction)
  - Business strategy (market penetration, start-up)
  - Branding (market premium)
  - Other factors unique to the firm and the industries

Value creation (con't)

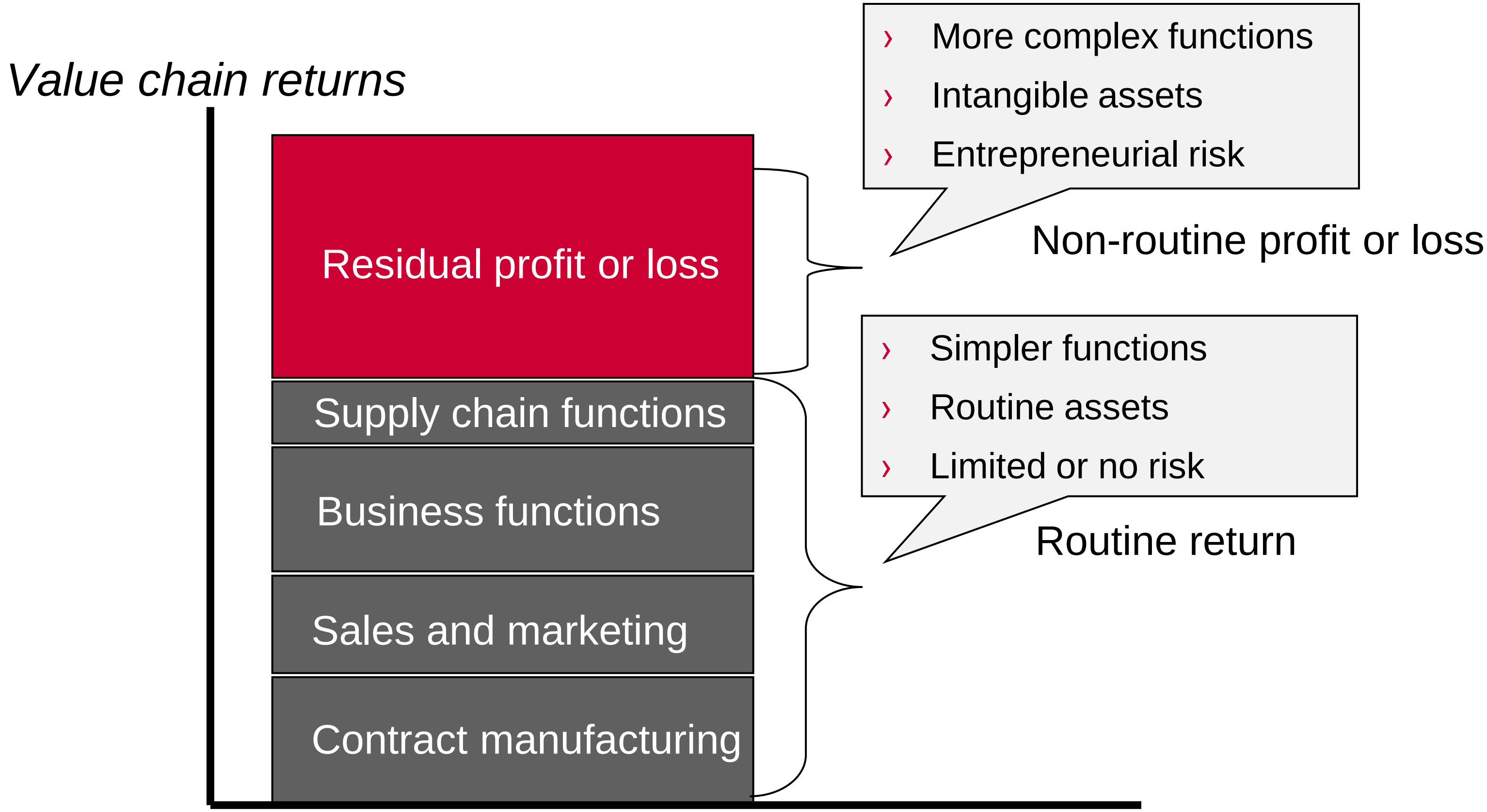


*Diagram not drawn to scale

Entity characterization

- Purpose of functional analysis is determination of proper entity characterization (or sometimes referred as the ‘functional profile’) of the respective parties within a value chain:
  - Routine entities: perform routine functions, have routine assets and bear limited risks
  - Entrepreneurial entities: perform non-routine functions, own intangibles or significant assets, bear key business risks

- Entrepreneurial entities
  - Lead other entities in a limited risk distribution model, and contract or consignment manufacturing structure
  - Coordinate overall business strategies, R&D, manufacturing, supply chain management, sales and marketing functions within the business value chain
  - Manage and assume significant risks associated with these functions (e.g. R&D risks)

Examples of common entity characterization

Functional profile

Entrepreneurial entities

- Entrepreneur
- Global/Regional Principal

Sales entities

- Sales and marketing service provider
- Sales agent
- Limited-risk distributor
- Full-fledged distributor

Manufacturing entities

- Consignment or toll manufacturer
- Contract manufacturer
- Full-fledged manufacturer

Service entities

- Support service provider
- Procurement service provider

Transfer pricing methods

Transfer pricing methods

- The OECD TPG set out five internationally accepted methods:

Traditional transactional-based methods	Profit-based methods
Comparable uncontrolled price (CUP) method	Transactional net margin method (TNMM)
Resale price method (RPM)	Transactional profit split method (PSM)
Cost plus method (CPM)	

- The selection of TP method(s) is based upon the ‘most appropriate’ method to take into consideration the nature of the transaction, degree of comparability between the comparable data and related party transactions, availability of reliable comparable data. Not one method is suitable in every possible situation.

Transfer pricing methods (con't)

- Five comparability factors:
  - Functions performed
  - Contractual terms
  - Risks assumed
  - Economic and financial conditions
  - Nature of property or services transferred
- Special circumstances:
  - Market share strategy
  - Differences in geographic markets
  - Location savings

Comparable uncontrolled price

- “The CUP method compares the price charged for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances.” (OECD TPG Paragraph 2.14)
  - Uncontrolled transaction has no differences that have a material effect on price. Reasonably accurate adjustments can be made to account for any differences
  - Comparability of actual goods and transactions are very important for the application of CUP method.
- Internal CUPs
  - Found from within the company or the Group. Examples such as the sale of products and/or services to both related and unrelated parties.
- External CUPs
  - Found from third-party transactions. Examples such as commodity prices listed on commodity indices.

Comparable uncontrolled price (con't)

Controlled transaction under review

Related manufacturer → Related distributor → Unrelated customer

Internal uncontrolled transaction

Related manufacturer → Unrelated distributor → Unrelated customer

Unrelated manufacturer → Related distributor → Unrelated customer

External uncontrolled transaction

Unrelated manufacturer → Unrelated distributor → Unrelated customer

» Determination of the price for controlled transactions with reference to the price under internal/external uncontrolled transactions

Comparable uncontrolled price (con’t)

Examples of comparability factors

- Terms, rights, exclusivity and geographic area
- Stage of development
- Rights to receive updates, revisions and modifications
- Uniqueness of the property
- Duration of the agreement and renegotiation rights
- Economic and product liability risks
- Existence of ongoing business relationships
- Functions performed by the parties
- Quality of good
- Contractual terms
- Level of market
- Geographic market
- Date of transaction
- Intangible property
- Foreign exchange
- Alternatives to buyer and seller
- Volume of transaction
- Financing terms

Comparable uncontrolled price (con’t)

Pros	Cons
» Most accurate support for arm's length TP if exact CUPs are available » Inexact CUPs obtainable depending on industry	» Difficult to achieve comparability in the absence of exact CUPs » Transactional data hard to find » External transactions hard to justify as comparable if comparability factors are appropriately considered » Difficult to make ‘reasonably accurate’ adjustments in practice

Resale price method (RPM)

- "The RPM begins with the price at which a product that has been purchased from an associated enterprise is resold to an independent enterprise. This price is then reduced by an appropriate gross margin on this price representing the amount of which the reseller would seek to cover its selling and other operating expenses and in light of the functions performed (taking into account assets used and risks assumed), make an appropriate profit." (OECD TPG Paragraph 2.27)
  - Gross profit margin is compared against that of the comparable uncontrolled transactions
  - Less product comparability may be required as compared to CUP but still a key factor
  - May not be applicable if the reseller add substantial value to the value of the product or contributes substantially to the creation or maintenance of intangible property associated with the product

Resale price method (con’t)

Controlled transaction under review

Related manufacturer → Related distributor → Unrelated customer

Internal uncontrolled transaction

Unrelated manufacturer → Related distributor → Unrelated customer

External uncontrolled transaction

Unrelated manufacturer → Unrelated distributor → Unrelated customer

» Determination of the gross profit margin achieved by the related distributor for controlled transactions with reference to the gross profit margin achieved under internal/external uncontrolled transactions

Resale price method (con't)

Examples of comparability factors

- Inventory levels and turnover durations, price protection offered by the manufacturer
- Contractual terms
- Warranty
- Exclusivity of right to resell
- Extent of sales, marketing and advertising functions performed
- Level of market
- Foreign currency risks
- Management efficiency, age of property, plant and equipment (PP&E), life cycle
- Financing terms

Common profit level indicators

- Gross margin

Resale price method (con't)

Pros	Cons
» Can be easily applied if internal comparable transactions are available (if reseller distributes to both unrelated and related parties)	» Has to be done on a gross-margin basis; therefore, accounting classification and different cost structure reduces reliability

Cost plus method (CPM)

- “The CPM begins with the costs incurred by the supplier of property (or services) for property transferred or services provided to an associated purchaser. An appropriate cost plus mark-up is then added to this cost, to make an appropriate profit in light of the functions performed and market conditions. This method is probably most useful where semi-finished goods are sold between associated parties, where associated parties have concluded joint facility agreements or long-term buy-and-supply arrangements, or where the controlled transaction is the provision of services” (OECD TPG Paragraph 2.45)
  - Cost plus mark-up is compared against that of the comparable uncontrolled transactions
  - Similar to RPM in that less product comparability may be required as compared to CUP but still a key factor
  - Particularly important to consider differences in the level and types of expenses associated with the activities performed

Cost plus method (con't)

Controlled transaction under review

Related manufacturer → Related distributor → Unrelated customer

Internal uncontrolled transaction

Related manufacturer → Unrelated distributor → Unrelated customer

External uncontrolled transaction

Unrelated manufacturer → Unrelated distributor → Unrelated customer

» Determination of the mark-up on gross costs applied the related manufacturer for controlled transactions with reference to the mark-up on gross costs achieved under internal/external uncontrolled transactions

Cost plus method (con't)

Examples of comparability factors

- Complexity of manufacturing
- Manufacturing, production and processes
- Procurement
- Testing
- SG&A efforts
- Foreign exchange
- Contractual terms
- Volume of transaction
- Financing terms
- Use of short-term lease assets vs. long-term lease or owned assets

Common profit level indicators

- Mark-up on gross costs

Cost plus method (con't)

Pros	Cons
» Can be applied for manufacturers and service providers if internal comparable transactions are available	» Has to be done on a gross-margin basis; therefore, accounting classification and different cost structure reduces reliability

Transactional net margin method (TNMM)

- “The TNMM examines the net profit relative to an appropriate base that a taxpayer realizes from a controlled transaction. This means in particular that the net profit indicator of the taxpayer from the controlled transaction should ideally be established by reference to the net profit indicator that the same taxpayer earns in comparable uncontrolled transactions or the net margin that would have been earned in comparable transactions by an independent enterprise.” (OECD TPG Paragraph 2.64)
  - Compares profitability of tested party against that of internal comparable uncontrolled transactions or independent comparable companies
  - Net profit indicators are usually less affected by transactional differences and may be more tolerant to functional differences compared to gross margins
  - Generally applied to the controlled party that is the least complex and has the fewest valuable intangibles (i.e. the least complex entity)
  - Potentially can adjust comparable companies’ financial data for differences in functions, risks and accounting methods

Transactional net margin method (con’t)

Controlled transaction under review

Related manufacturer → Related distributor → Unrelated customer

Internal uncontrolled transaction

Related manufacturer → Unrelated distributor → Unrelated customer

External uncontrolled transaction

Unrelated manufacturer → Unrelated distributor → Unrelated customer

» Determination of an appropriate net profit indicator applied by the related manufacturer for controlled transactions with reference to the same net profit indicator achieved under internal/external uncontrolled transactions

Transactional net margin method (con't)

Examples of comparability factors

» Economic sectors or markets
» Business experience (mature vs. start-up)
» Business or product life cycle
» Management efficiency
» Property, plant and equipment age
» Intangible property
» Lines of business
» Size of business
» Asset mix

Common profit level indicators

» Operating margin / Return on sales
» Mark-up on total costs / Net cost plus
» Return on total assets
» Return on operating assets
» Return on capital employed
» Berry ratio (i.e. Ratio of gross profit to operating expenses)

Transactional net margin method (con't)

Pros	Cons
» Profit level indicators less affected by transactional differences » Product differences not as important as in other methods » Allows for certain aggregation of transaction types » Availability of data (tested party and comparables) that facilitates analysis » Broad acceptance by most tax authorities	» Often used as "one size fits all" and prevents critical analysis of other methods » Trends toward simplistic assessment of transfer prices (e.g., assertions that all limited risk entities should be profitable) » Could provide a one-sided story, since only one party to the transaction is selected for testing

Transactional profit split method (PSM)

- “The PSM seeks to establish arm’s length outcomes in order to approximate the results that would have been achieved between independent enterprises engaging in a comparable transaction. The method first identifies the profits to be split from the controlled transactions and then splits them between the associated enterprises on an economically valid basis that approximates the division of profits that would have been agreed at arm’s length.
- The transactional profit split method is particularly useful when the compensation to the associated enterprises can be more reliably valued by reference to the <u>relative shares of their contributions to the profits</u> arising in relation to the transaction(s) than by a more direct estimation of the value of those contributions.” (OECD TPG Paragraph 2.114)
- Most relevant where each parties to the transaction brings unique and valuable contributions that are key sources of actual or potential economic benefits in the business operations and/or operates within a highly integrated business operating model

Transactional profit split method (PSM) (con't)

Controlled transaction under review

Related manufacturer → Related distributor → Unrelated customer

- » Related manufacturer and related distributor both contribute in unique and valuable manner (e.g. product IP, manufacturing know-how, extensive sales and distribution network, unique/special market access)
- » Determine profits to be split from the controlled transaction
- » Determine the split of profits between the related manufacturer and related distributor based on an economically valid basis that approximates the division of profits that would have been agreed at arm's length
  - › Either with reference to similar transactions entered into by independent enterprises or;
  - › Based on analysis of the relative contribution brought forward by the respective parties.

Transactional profit split method (PSM) (con't)

- Two types of profit splits:
  - Comparable analysis: Total profits are divided between the associated enterprises to arrive at a reasonable approximation of each enterprises' relative total contribution
  - Residual analysis: Two-step process:
    - Assign a market return to routine functions performed by each associated enterprise (using other methods, such as TNMM)
    - Allocate residual profit based on the relative value of non-routine contributions of each associated enterprise
- Potential methods of approximating relative value include:
  - Relative R&D expenditures incurred/capitalized in developing intangibles
  - Relative compensation of key people functions
  - Relative costs incurred or estimated value generated by activities performed

Transactional profit split method (PSM) (con’t)

Pros	Cons
» Does not rely directly on closely comparable transactions » Allows flexibility and customization by taking into taxpayers’ specific or unique facts and circumstances » Parties to the controlled transaction may be attributed to a reasonable result based on their relative contribution, since both parties are evaluated	» Difficult to apply in practice because profit split does not typically occur in business dealings among independent parties » Highly subjective exercise to evaluate each party’s contributions to profits and bases of splitting profits

Selection of TP methods - Considerations

Technical considerations

- Are there comparable transactions with third parties?
- Five comparability factors:
    - Functions performed
    - Contractual terms
    - Risks assumed
    - Economic and financial conditions
    - Nature of property or services transferred
- What is the global TP practice for the client's wider group in relation to this transaction?
- What is the industry practice for the related party transaction?
- Are the parties to the transaction making unique and highly valuable contributions to the value created by the transaction or overall value chain?
- Is one of the entities in the related party transaction relatively low function or low risk or the "simple" entity in the transaction?
- Is the TP method impacted by the economic phase of the related parties (for example, start-up phase)?
- Are there regulatory (tax or other) considerations that impact the TP set-up and method?

Selection of TP methods – Considerations (con’t)

Practical considerations

- Availability of comparable data
- Availability of qualitative information about the comparable companies or agreements
- Ability of company to measure data in line with comparable company data
- Ability to make reasonably accurate adjustments to account for any immaterial differences?

Selection of TP methods – Typical outcome

Situation	Pricing method	Property or typical functions to be priced	Basis for setting price	Cases where method Used
Direct observation of market prices can be used to set transfer prices	CUP	Tangible or intangible property or various functions	Market price	Same or similar tangible or intangibles transactions
Comparables are available to set margins for one of the related parties performing comparatively routine activities	RPM	Tangible property or distribution functions	Comparables' gross margins	Routine distribution activities
	CPM	Tangible property or manufacturing functions	Comparables' gross profit mark-ups	Routine manufacturing activities
	TNMM	Tangible or intangible property or various functions	Comparables' operating profit, return on capital employed or other indicator	Routine distribution and manufacturing activities
Adequate comparables are not available to set margins for either related party	PSM	Tangible or intangible property or various functions	Multiple valuation techniques used to price routine and non-routine functions	Complex situations
	Other methods (where permitted)	Tangible or intangible property or various functions	Make-or-buy analyses, determination of cost of capital, cash flow analyses and other valuation techniques	Various

Application of TP methods

Application of TP methods

- The purpose of this section is to explain how the taxpayer has applied the selected TP method to evaluate the arm's length nature of the related party transaction.
  - Explain the process to identify comparable benchmarking data – databases are typically used to identify comparable data. If using a database, describe the nature of the database and the search process that will be followed to identify comparable agreements or companies.
  - Explain the comparability of the selected data – this section would explain the key comparability factors taken into consideration when selecting the comparable data.
  - Comparison of comparable data with tested party data – this section should show the computation of the necessary financial data using the applicable profit level indicators and compare these to the taxpayer's data in the covered transaction.
  - Concluding remarks – this section should show how the taxpayer's results applying the applicable TP method are consistent with the comparable benchmarking data.

Benchmarking process

- Databases are typically used to generate benchmarking data for TP purposes:
  - Methods using comparable company data, such as Orbis, Osiris and other local country databases
  - Market reference price data accessed on databases or public indices
  - Third party agreements, such as RoyaltyStat
  - For financing transactions:
    - Credit rating analysis, such as Moody's KMV RiskCalc or Refinitiv StarMine
    - Interest rate benchmarking, such as Refinitiv Eikon database
- When using a database, there will be automated search and manual review criterion:
  - Automated search criteria typically relate to:
    - Industry codes, independence status of the companies, size of the companies, continued operations or availability of financial data, geographic region or countries
  - Manual review criteria is typically determined based on internet and other research to determine the following:
    - Nature of product or service comparability, functional comparability, related party transactions, similarity of economic and financial conditions

Benchmarking process (con't)

- Overall, the description of a benchmarking search process should include the following:
  - An explanation of the process used to identify benchmarking data
  - The results from undertaking a benchmarking analysis
  - Whether adjustments were made to the data in the benchmarking analysis and what immaterial differences were these adjustments in relation to
  - Methodology in the application of the adjustments
  - How the data should be interpreted in terms of substantiating the arm's length nature of the taxpayer's transaction
  - Detailed appendices that show the process used and data generated or used in the search

Benchmarking process (con't)

- Potential adjustments to be made to account for:
  - Different levels of inventory (e.g. limited risk distributor, toll manufacturer)
  - Working capital
  - Asset intensity
  - Location savings
  - Geographic markets
  - Property, plant and equipment
  - Foreign currency
  - Economic cycle

Benchmarking process (con't)

» Key things to note when reviewing the comparables selected:
  - Typically there are no "perfect comparables".
  - Review product, service and functional comparability, as well as overall arm's length circumstances.
  - Major competitors will often not be in the comparable data because these competitors may also have related party transactions, which means they cannot be used as a reliable indication of arm's length prices or margins.
  - The use of loss making companies depends on the functional or risk profile of the tested party – loss-making may be defined based on local country TP regulations
  - Reasonableness of comparability adjustments performed on the tested party or data selected.

Benchmarking results – Profit level indicators

TP method	Profit Level Indicator	Calculation
RPM	Gross margin	Gross profit / net sales
CPM	Mark-up on costs	Gross profit / COGS
TNMM	Mark-up on total costs	Operating profit / (COGS plus Operating expenses
	Berry ratio (or return on operating expenses)	Gross profit / Operating expenses
	Operating margin	Operating profit / net sales or revenue
	Return on capital employed	Operating profit / average operating assets
	Return on assets	Operating profit / average total assets

Benchmarking results – Arm's length range

» Selection of the appropriate point within range

› Generally accepted to use interquartile ranges (note that different country may have varying definitions of interquartile)

› Ability to apply full ranges for CUP where all selected comparable are deemed to be equally comparable to the related party transaction

» Use of single year vs. multiple year comparable data

› Generally accepted to use multiple year comparable data to factor in business and product life cycles of the comparable data

› Consider use of weighted averages rather than simple averages

› Pooled averages may be useful in instances where there are limited information available, but may not be accepted to certain tax jurisdictions

Application of TP methods – Practical considerations

» TP approach:
  › Whole-of-entity testing (aggregation of transactions) versus transaction-by-transaction
» Different local country benchmarking requirements:
  › Local comparables, use of database, independence criteria
» Consistency across multiple benchmarking studies:
  › Approach to select and reject comparables, SIC codes, covered period, use of same multiple year period
» Different financial results from multiple or corroborative benchmarking studies:
  › Non-overlapping interquartile ranges

Application of TP methods – Concluding remarks

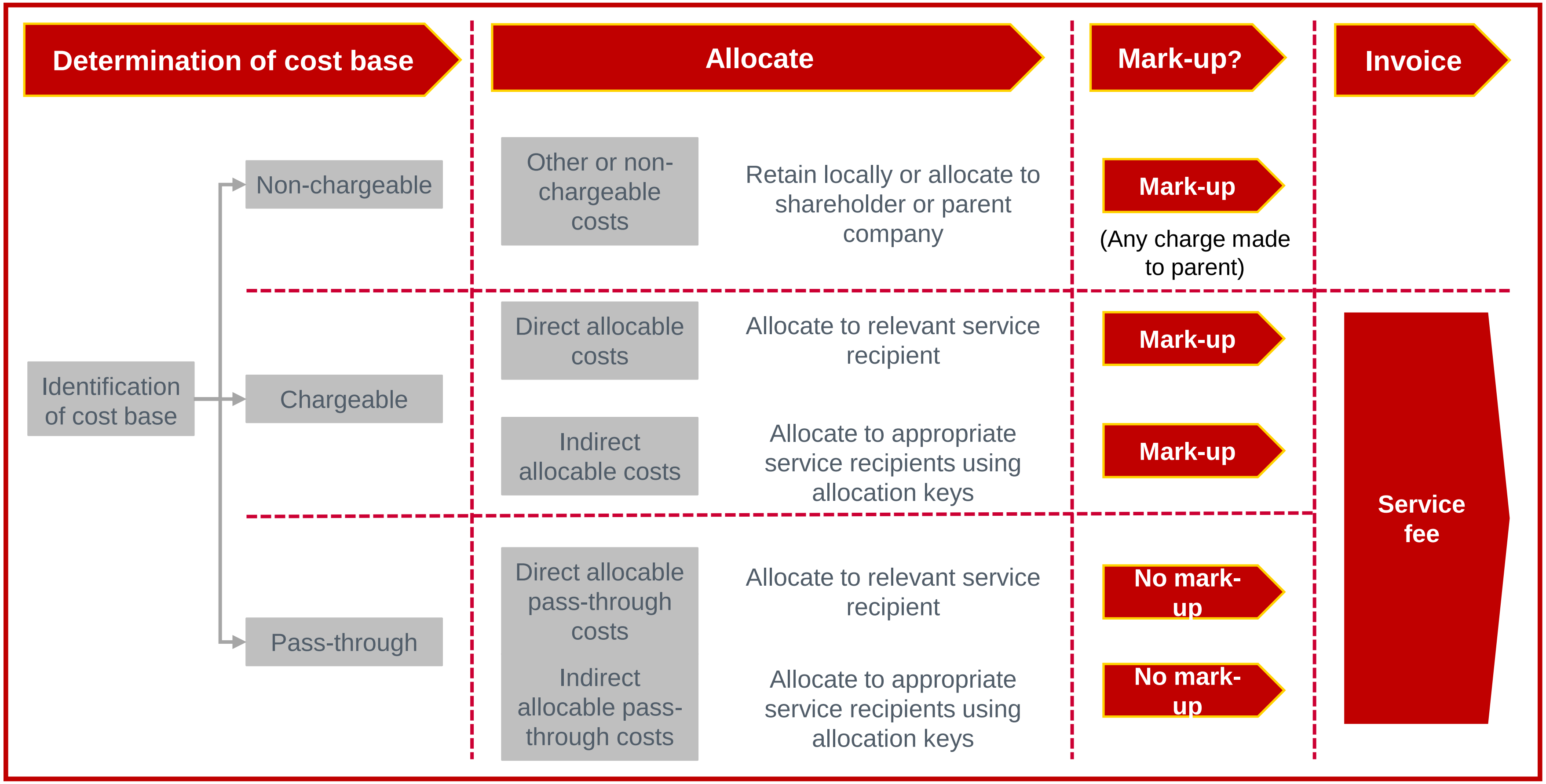
- Comparison of the arm's length range against the actual results achieved for the taxpayer.
- There may be are commercial factors that result in a TP position that may differ from the arm's length range established. In these cases, a special factor analysis may be needed:
  - Prepare justification for why there is a difference between third-party data and the taxpayer
  - Identify the commercial reasons for operating losses or low levels of profit or other deviations from consistency with practice used for comparable dealings with third parties, such as:
    - Are there country specific factors or business strategy reasons that differentiate the related party transaction?
    - Is the business in start-up mode? If so, explain the current cost structure and business projections
    - Are there specific operational reasons or risk factors that have materialized?

Intercompany services

Key concepts to intercompany services

» Concept of a “Benefits” test:
  - A service is considered to have been provided when activities are performed for another party who receives, or reasonably expects to receive, benefit from such activities.
  - When there is a reasonable expectation or intention for benefit to be conferred or received, a provision of service is considered to have taken place even if the expected benefit does not eventually materialise.
  - There must be commercial or practical necessity for the activities to be performed and an independent party who is willing to pay for the performance of those activities. Where the benefit is too remote, no service is considered to be provided.
  - A benefit must have economic or commercial value such that an independent party would expect to pay to receive it or be paid for supplying it.
  - The benefits must be identifiable and capable of being valued. In other words, the benefits must be sufficiently direct and substantial.

Elements of a service charge mechanism



Determination of cost base – Non-chargeable costs

- No direct or measurable benefit is bestowed on the service recipient.
- Generally three categories of non-chargeable costs:
  - Shareholder costs (e.g., costs relating to Group statutory reporting, shareholder meetings)
  - Costs relating to acquisition or development of new businesses (unless services were taken for specific Group entity)
  - Duplicate services and incidental benefit
- Costs are borne by the parent entity of the Group:
  - Non-chargeable costs incurred by a subsidiary on behalf of the parent entity should be allocated back to the parent

Determination of cost base – Chargeable costs

- Services provide an economic benefit to the service recipient.
- Three components of chargeable cost base:
  - Direct costs: Costs specific to a particular service (payroll costs, employee-related costs)
  - Overheads: Day-to-day running costs that are allocated based on cost drivers (e.g. office rental)
  - Costs from internal service providers (e.g. HR, IT, Finance)

Determination of cost base – Pass-through costs

- Services provided when acting only as an agent or intermediary in the provision of services.
  - Remuneration for the performance of an agency function rather than for the performance of the services themselves.
  - Apply mark-up on the cost of the agency function, instead of the services provided by third parties
  - For example, costs of renting office space on behalf of group entities that group entities would have incurred directly had they been independent.
- In instances where the service provider does not enhance the value of the acquired services.

Allocation of costs

- » Direct-charge method:
  - › Benefit of services provided can be directly connected with a specific service recipient.
  - › Costs incurred in providing the services are recharged directly to the specific service recipient(s) with an arm's length mark-up.
- » Indirect-charge method:
  - › Costs cannot be directly assigned to a particular service recipient.
  - › Costs incurred in the provision of such services are allocated across multiple service recipients with an arm's length mark-up.
  - › Allocation of these costs are performed through a reasonable allocation key (i.e., a metric that reasonably correlates and is commensurate with the amount of benefit related parties receive or are expected to receive).

In most instances, MNEs rely on the indirect-charge method as majority of intercompany service functions are performed for the benefit of multiple service recipients

Transfer pricing documentation

OECD Three-tiered approach to transfer pricing documentation

Master file

Broad information about the multinational corporation's (MNC) business, TP policies and agreements with tax authorities in a single document available to all tax authorities where the MNC has operations

Local file

Detailed information about the local business including related party payments and receipts for products, services, royalties and interest etc.

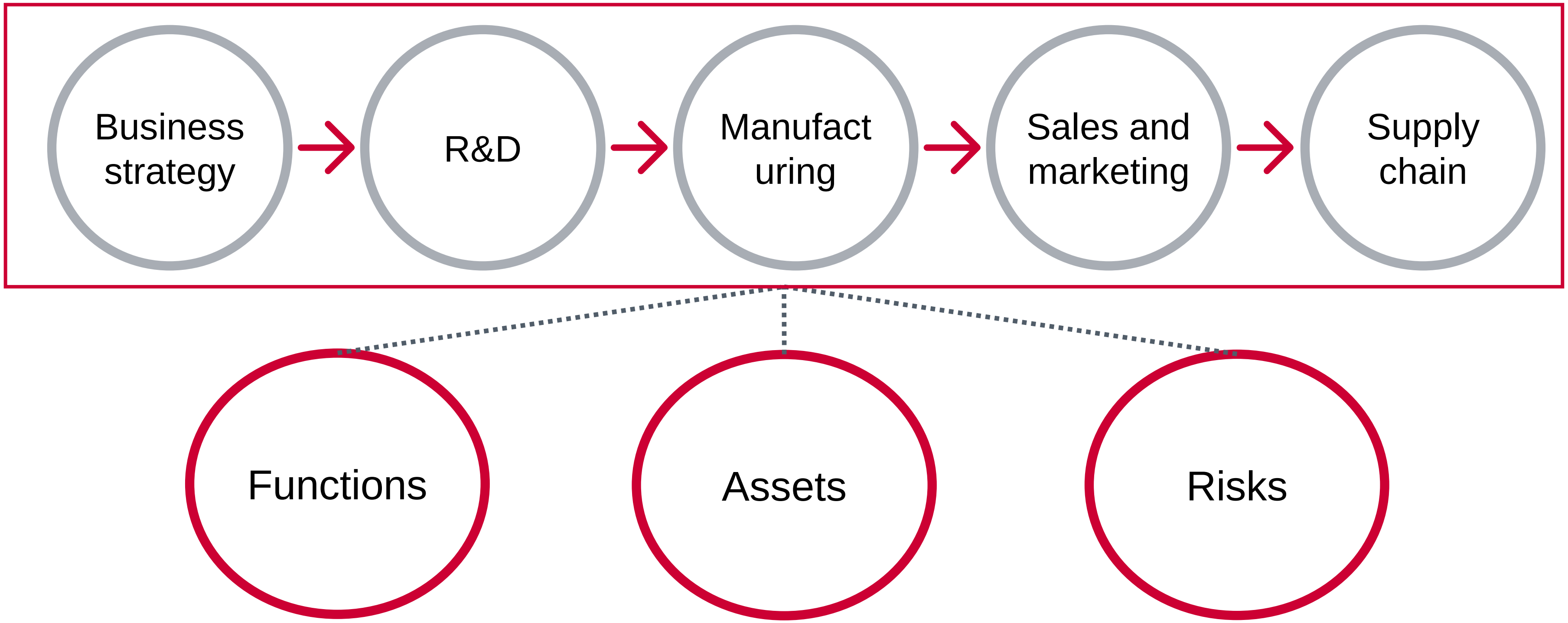
Country by Country Reporting (CbCR)

Broad information about the jurisdictional allocation of profits, revenues, employees and assets

Note: Additional analysis/information may be required to meet specific local country transfer pricing documentation requirements

Value creation

How key value chain processes are managed



Contributors to value chain profits

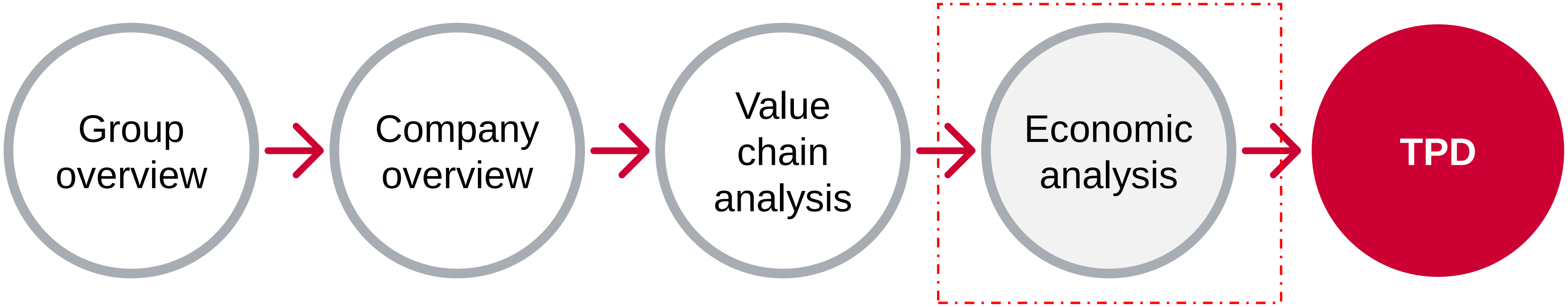
A TP analysis should take into consideration the business unique value chain processes and its key value drivers

TP documentation – Factual sections

Group overview → Company overview → Value chain analysis → Economic analysis → **TPD**

- The factual sections of a TP report can consist of the following:
  - Group overview: This section provides an overview of the MNE group business, such as the nature of its business operations and economic activities performed, transfer pricing policies, allocation of income.
  - Company overview: This section provides more detailed information of a specific entity, such as the business segments involved, entity-level organizational structure, local financial information and key features of the local operations.
  - Value chain analysis: The section describes the functional profiles of and activities performed by the parties within the business value chain which will subsequently justify the economic analysis portion of the TP report.

TP documentation – Economic sections



- The economic analysis sections of a TP report can consist of the following:
  - Overview of local country TP framework and relevant parts of the OECD where applicable.
  - Description of selection of the TP methods – describe the five TP methods (and any local country variations) and the economic and practical considerations (discussed shortly) should be described here to explain why the applicable TP method has been selected.
  - Application of the TP methods – relevant benchmarking analyses performed to arrive at the arm’s length results

wts global

TP documentation – Relevant sections

Group overview

Company overview

Value chain analysis

Economic analysis

Master file

- The Masterfile will mostly reflect the Group information and to a lesser extent the company information.
- It will also reflect a brief overview of the value chain analysis and may include an overview of the transfer pricing method(s) applied to remunerate entities within the value chain.

Local file

- The Local file will mostly reflect the company information and to the extent required, the Group information (e.g. business segments).
- The Local file will reflect the elaborated details of the value chain analysis, drilling into details of the functions, assets and risks and the entity characterization.
- The Local file will detail the selection and application of the transfer pricing method(s) in arriving at the economic conclusions on the arm’s length nature of the related party transaction.

TP documentation – Key information

Group / Industry

- Key performance drivers and business risks of industry
- Details of business restructurings (if any)
- Group intangible strategy
- Group financing arrangements and primary sources of financing

Company

- Key value drivers of the company
- Business model and key elements within the business
- Business segments and nature of products and services
- Drivers for Group and Company financial results

TPD

Value chain

- Key functions and processes
- Activities performed by respective departments/business units
- Use of intangibles and management/assumption of risks

TP set-up

- TP method applied to arrive at transfer prices and the use of budgeted or actual financials
- Actual TP results against benchmarked results
- Existing tax rulings/APAs

Master file

OECD Master file and Local file

- Master file
  - Common standardized information relevant for all MNC group members – aimed at providing an overview of MNC's entire business operations.
  - OECD asserts pre-BEPS documentation practice typically does not provide "big picture" and value chain analysis for risk assessment purposes.

Master file – Content requirements

Section	Content	Comment
Organizational structure	» Legal and ownership structure, location of all operating entities	» Include the full organization chart of the group as of the relevant fiscal year end, with locations of each entity. » The organization chart should also include branches, partnerships, joint ventures (JV), representative offices (anything with a physical presence).
Description of MNC's business	» List of important profit drivers	» Identify important drivers of business profits. » Consider what are the key business risks. » E.g., Service companies – Reputation, track record, etc. » E.g., Product companies – Technology, IP, know-how, etc.
	» Description of supply chain for the group's five largest products and/or service offerings plus any other products and/or services greater than five percent of group turnover » Description of main geographic markets of the products and services identified above	» Depends on how the products and/or service offerings are defined within the organization. » If there are no obvious top five product and/or service offerings, or the five largest product and/or services are not representative, an alternative approach of selecting the products and/or service offerings needs to be considered. » To the extent that more than one Master file (e.g., business unit Master files) is produced, consider presenting the five largest products and/or service offerings per business unit.

Master file – Content requirements (con't)

Section	Content	Comment
Description of MNC's business (con't)	» List and description of important related party service arrangements between members of the multinational enterprise (MNE) group, other than research and development (R&D) services (including a description of capabilities of principal locations providing important services and related TP policies)	» This section should cover all important arrangements whether or not they are documented in a written agreement. » A service arrangement that involves several countries or is a fundamental part of the MNE's operating model should be described in this section.
	» Functional analysis of the principal contributions to value creation by individual entities within the group	» It is recommended that this section be brief in describing the different entity profiles within the group as the more detailed transaction–based functional analysis will be elaborated in the Local file. » All active entities (including both routine and non–routine entities) should be covered.
	» Description of important business restructuring transactions, acquisitions and divestitures occurring during the fiscal year	» Important business restructuring transactions are those that impact TP in multiple entities. » Restructuring transactions that have an impact on the overall operating or business model should be considered. » Any business restructuring that impacts only one entity may appear in the Local file.

Master file – Content requirements (con’t)

Section	Content	Comment
Intangibles	» Description of overall strategy for development, ownership and exploitation of intangibles (including location of principal R&D facilities and location of R&D management)	» It is recommended that these three requirements are dealt with together, and include any intangible that develops residual profit. » Need to identify which entities legally own the intangibles, funds the intangibles and contribute to the development, enhancement, maintenance, protection and exploitation of the resulting intangibles.
	» List of intangibles or groups of intangibles of the MNE group that are important for TP purposes and which entities legally own them	
	» Description of the group’s TP policies related to R&D and intangibles	
	» List of important related party agreements relating to to intangibles (including cost contribution arrangements, principal research service agreements and license agreements)	» In principle, list agreements related to the intangibles described above. » In general, any written agreement related to intangibles would be considered important.
	» Description of important internal transfers of interests in intangibles during the relevant year (including the entities, countries, and compensation involved)	» Transfers of interests in intangibles and/or a transfers that lead to a fundamental change of the MNE’s operating model should be described in this section. » It is recommended that a description of the intangible(s) transferred, the entities involved and their country of residence, the timing of the transfer, price, and terms and conditions of the transfer be included.

Master file – Content requirements (con't)

Section	Content	Comment
Intercompany financial activities	» Description of how the group is financed (including important financing arrangements with unrelated lenders)	» This section should be consistent with publicly available information such as annual reports of the group. » The description should also be aligned with the functional analysis, where applicable.
	» Identification of central financing entities and their place of organization and operation	
	» Description of TP policies for intercompany financing arrangements	
Financial and tax positions	» MNE's annual consolidated financial statement for the fiscal year concerned	» This section should be consistent with publicly available information such as annual reports of the group. » To reduce administrative burden, should consider using materials already prepared.
	» List and description of MNE group's unilateral advance pricing arrangements (APA) » List and description of other relevant tax rulings related to the allocation of income to particular jurisdictions	» The level of detail to be provided in this section should be considered on a case-by-case basis, taking into consideration the group's disclosure strategy.

Master file – Content requirements (con't)

- Considering that the Master file is a high level overview of the MNE, it is not intended to provide an exhaustive list of information (e.g., a listing of every patent owned by members of the MNE group) as this would be both unnecessarily burdensome and inconsistent with the objectives of the Master file.
- In preparing the Master file, taxpayers should use prudent business judgment in determining the appropriate level of detail for the information supplied, keeping in mind that it is to provide tax administrators with a high-level overview of the MNE's global operations and policies.
- For the purposes of preparing the Master file, information is considered important if its omission would affect the reliability of the transfer pricing policies and their outcomes.
- The Master file should lead the readers to make conclusions on how and from where the Group derives its profit.

Local file

OECD Local file

» Local file

- › Supplements the Master file and aimed at providing entity-level transactional information for material transactions (material in the context of the local country's tax system).
- › Relevant financial data and intercompany transaction details for local entities to be included in Local file.
- › Detailed information to determine whether a specific transaction is at arm's length would include:
  - Robust functional analysis by transaction
  - Comparability analysis
  - Method selection and application

Local file – Content requirements

Section	Content	
Local entity	» Local organization chart and description of management structure, individuals and country location of individuals to whom local management reports » Detailed description of local business strategies » Details of business restructurings or intangible transfers	
Controlled transactions	» Description of the transaction (e.g., manufacture, distribution of goods etc.) and context in which it takes place (e.g., business activity, financial activities of the MNC group, cost contribution arrangement) » Aggregate amount of intercompany charges, including interest, royalty and fees for services paid and received » Identification of associated parties involved in each controlled transactions, and relationship amongst them » Detailed functional analysis with respect to each controlled transaction (i.e., functions performed, assets used and risks borne) » Selection of most appropriate TP method and reasons for selection, as well as selection of the tested party	» Other relevant related party transactions » Important assumptions made in applying the TP methodology, explanation for performing multi-year analysis (if relevant) » Description of selected comparable uncontrolled transactions, comparable search methodology and sources » Comparability adjustments performed » Reasons for concluding that relevant transactions were conducted on an arm's length basis based on the application of the selected method » Summary of financial information used to apply the TP method » Copy of existing unilateral, bilateral and multilateral APAs, and other tax rulings to which the local tax jurisdiction is not a party but are related to the controlled transactions

Local file – Content requirements (con't)

Section	Content
Financial information	» Annual local entity financial accounts for the relevant year » Information and allocation schedules showing how the financial data used to apply the TP method may be tied to the annual financial statements » Summary schedules and sources of relevant comparable financial data

Practical considerations for TP documentation

- Consider specific local country requirements including additional content/disclosures (e.g. Indonesia Master file), translation requirements, documentation submission deadlines and other disclosure requirements (e.g. TP return forms)
- Consider how Master file and Local files can support MNE's CbCR position (if applicable), including considering "sub-files" (e.g. business divisions, segments or regions) to present focused information and bridge the gap between the Master and Local file – particular where different business units within the Group may skew the information provided for CbCR
- Local file can be either the OECD local template or traditional local TP documentation (non-OECD jurisdictions) focusing on local entity functional characterization.
- Data presented should be reconciled or be capable of being reconciled to information submitted to tax authorities (e.g. audited financial statements, tax return submissions).

Country-by-country reporting

CbCR – Requirements

- Multinational groups with consolidated revenue of EUR 750m or more
- Filing with tax authority in parent country, to be shared with tax authorities in countries where group has entities or branches
- Secondary reporting either directly by each local entity or for group by “Surrogate Parent Entity”
- Provides high level information about MNC’s jurisdictional allocation of revenue, profit, taxes, assets and employees to be shared with all tax authorities where MNC has operations
- Information on revenue, profit, tax (cash and accrued), stated capital, accumulated earnings, tangible assets and employees provided on a CbC aggregated basis
- Entity-level information on principal businesses and country of tax residence versus country of organization

CbCR – Reporting template

Table 1

Name of the MNE group: Fiscal year concerned: Currency used:											
Tax jurisdiction	Revenues			Profit (loss) before income tax	Income tax paid (on cash basis)	Income tax accrued – current year	Stated capital	Accumulated earnings	Number of employees	Tangible assets other than cash and cash equivalents
	Unrelated party	Related party	Total							

Table 2

Name of the MNE group: Fiscal year concerned:															
Tax jurisdiction	Constituent entities resident in the tax jurisdiction	Tax jurisdiction of organisation or incorporation if different from tax jurisdiction of residence	Main business activities												
			Research and development	Holding of managing intellectual property	Purchasing or procurement	Manufacturing or production	Sales, marketing or distribution	Administrative, management or support services	Provision of services to unrelated parties	Internal group finance	Regulated financial services	Insurance	Holding shares or other equity instruments	Dormant	Other

CbCR – Risk assessment by tax authorities

- Tax authorities use CbCR as a means of achieving standardized reporting and information collation across jurisdictions.
- CbCR provide information for tax authorities to:
  - Undertake risk assessment
  - Take compliance action, conduct audit
  - Share intelligence
- Generally, CbCR would give rise to increased transparency and more disclosure of Group information to tax authorities, resulting in:
  - More scrutiny and tax audit risks
  - Increased compliance burden to collate and present required information
  - Greater risk for higher taxes

CbCR – Readiness

Obligations	» Determine filing obligations within the group and consider potential surrogate filing locations as required » Determine notification obligations within group
Information collation	» Ease of data collection across potentially multiple databases » Aggregation rather than consolidation » Consistency of data collection year-on-year
Risk assessment	» What does the CbCR results tell? » Are there significant anomalies that may need further explanation? » What are the risk areas and opportunities for further consideration?

Other types of documentation

Other types of documentation

- Intercompany agreement – outlines the contractual terms underlying the related party transaction and forms a supporting document.
- TP policy document – Provides guiding principles of the TP methods to be used for intercompany transactions within a Group. It may provide descriptions of intercompany transactions, the methodology for applied for each transaction.
- Operating manual – outlines the relevant roles and responsibilities of different teams (e.g. finance and tax) to ensure optimal implementation of the TP policies. It may include references to the data or link to ERP system in order to collect and apply the TP policies, parameters under which the transaction should occur and frequency of charges and related administrative practice relating to the TP policy
- Business case or commercial justification – outlines the commercial reasons for changes in the business model or commercial reasons for variance between budget and actual results of revenue, profit etc.

Snapshot of Asia Pacific documentation requirements

Regional TP documentation requirements

Tax jurisdiction	CbCR	Master file	Local file	Comments
Australia	Yes, notification form to be filed separately through Local Files	Yes, must be made available within 12 months after FY	Yes, must be prepared on a contemporaneous basis, prepared before local corporate tax return is filed (6.5 months following year-end)	Broadly consistent with OECD, with local specific requirements. Simplified record-keeping options may be applicable.
China	Yes, no notification required	Yes, must be made available within 12 months after FY	Yes, must be prepared on a contemporaneous basis, prepared before local corporate tax return (31 May)	Broadly consistent with OECD, with local specific requirements (e.g. location-specific advantages, six tests for intra-group services).
India	Yes, notification form to be filed separately	Yes, must be made available on or before the due date of the corporate tax return	Yes, must be prepared on a contemporaneous basis, prepared before local corporate tax return (30 November)	Broadly consistent with OECD. Local comparable companies required. Specific definition of acceptable range. Also has additional requirements for Masterfile relative to OECD.
Indonesia	Yes, notification form to be filed separately	Yes, must be made available within four months after FY	Yes, must be prepared on a contemporaneous basis, prepared within four months after FY	Broadly consistent with OECD, with local specific requirements.

Regional TP documentation requirements (con't)

Tax jurisdiction	CbCR requirements	Master file	Local file	Comments
Japan	Yes, notification form to be filed separately	Yes, must be made available within 12 months after FY	Yes, must be prepared on a contemporaneous basis, prepared before local corporate tax return (3 months following year-end)	Consistent with OECD. Local comparable companies required where tested party is in Japan
Korea	Yes, notification form to be filed separately	Yes, must be made available within 12 months after FY	Yes, must be prepared on a contemporaneous basis, prepared before local corporate tax return (3 months from year-end)	Consistent with OECD. Local comparable companies required where tested party is in Korea
Malaysia	Yes, notification form to be filed separately	Yes, need to be submitted when requested	Yes, must be prepared on a contemporaneous basis, prepared before local corporate tax return (7 months from year-end)	Broadly consistent with OECD. Local comparable companies preferred
New Zealand	Yes, no notification required	Not mandatory, cost-risk assessment basis	Not mandatory, cost-risk assessment basis. Any documentation prepared needs to be on contemporaneous basis before local corporate tax return (7 July)	Consistent with OECD. Specific deductibility rules connected to inbound loans.
Pakistan	Yes, notification part of tax return	Yes, need to be submitted when requested	Yes, must be submitted when requested	Consistent with OECD.

Regional TP documentation requirements (con't)

Tax jurisdiction	CbCR requirements	Master file	Local file	Comments
Philippines	Not applicable	Not applicable	Local TP documentation to be prepared on a contemporaneous basis, prepared before local corporate tax return (3.5 months following year-end)	Broadly consistent with OECD.
Singapore	Yes, no notification required	Not applicable	Local TP documentation to be prepared on a contemporaneous basis, prepared before local corporate tax return (30 November)	Broadly consistent with OECD.
Taiwan	Yes, notification part of tax return	Yes, must be made available within 12 months after FY	Yes, must be prepared on a contemporaneous basis, prepared before local corporate tax return (31 May)	Broadly consistent with OECD.
Thailand	Not applicable	Not applicable	Local TP documentation to be prepared on a contemporaneous basis, prepared before local corporate tax return (150 days after year-end)	Broadly consistent with OECD. New rules applicable from 1 January 2019 onwards.
Vietnam	Yes, no notification requirements	Yes, need to be submitted within 15 days when requested	Yes, need to be submitted within 15 days when requested	Broadly consistent with OECD.

Overview of transfer pricing controversy

ASEAN TP controversy landscape

- ASEAN TP controversy landscape is evolving rapidly with new tax and transfer pricing related regulations issued in the recent years
- Increased tax and transfer pricing audit activities from local revenue authorities
- Generally, there's a high likelihood of a general TP audit for taxpayers operating across ASEAN
- Most ASEAN countries have implemented TP requirements that are enforceable and have seen alignments with the broader OECD BEPS Initiatives
- Interpretation of transfer pricing principles and applications is jurisdiction specific
- Cross-tax implications of tax audits linking direct and indirect taxes as well as transfer pricing

TP controversy – Trends and observations

- Common triggers of TP queries
  - Large quantum of related party transactions
  - “Transfer pricing” adjustment entries
  - High fluctuations in certain related party expenses, for e.g., royalty expenses, management fees
  - Significant related party interest expenses
  - Consistent operating losses
  - Low gross or operating margins compared to industry benchmarks
  - Cost sharing arrangements

TP controversy – Trends and observations (con’t)

Type of transactions	Nature of tax queries
Sales and purchases of tangible goods	» TP documentation and benchmarking support » Reasons for losses (if any)
Intercompany services	» Basis of charge » Nature of underlying cost base » Mark-up applied and benchmarking support (local benchmarking, if any) » Whether benefits have been received
Royalty transactions	» Royalty rates applied and benchmarking support » Details of the underlying intangibles
Intercompany financing transactions	» Basis of interest charge » Interest rates applied and benchmarking support (often referenced to local bank rates) » Thin capitalization aspects

Nature of information requested during TP controversy

- Prior exam and appeals reports
- TP documentation
- Evidence of transaction occurring and benefits of transaction
- Detailed segmented accounts and computation data and calculations
- Detailed cost base of intercompany transactions
- Customs import and export duty pricing information
- Intercompany agreements
- Internal audit reports
- List of corporate policy and procedure manuals, including intercompany pricing policies
- Corporate meeting minutes
- Sales catalogues, brochures and pamphlets
- Newspapers, journals, periodicals and reference materials
- Company websites – headquarter and foreign companies

Expected increase in TP controversy

- Forms of information exchange and sharing
  - Automatic exchange of information
  - Spontaneous information exchange
  - Exchange of information upon request
  - Presence of foreign officials
  - Simultaneous tax examinations
  - Joint audits
- General legal basis for information exchange
  - Art. 26 OECD Model Tax Convention
  - Art. 8, 9 Convention on mutual administrative assistance in tax matters

Transfer pricing risk management

Tax risk management maturity of taxpayers

Basic

- No tax strategy
- Little proactive tax controversy planning
- Weak or uncoordinated approach to tax controversy and risk
- Limited awareness of tax controversy trends at a country level
- Limited or no dialogue with tax authorities in key jurisdictions

Established

- Documented tax strategy
- Standardized approach to tax controversy and risk at a country level
- Management of tax controversy trends at a country level
- Limited consideration for exchange of information
- Standard level of dialogue with tax authorities in key jurisdictions

Leading

- Tax strategy and aspects considered on key business issues
- Globally integrated approach to tax controversy and risk
- Management of tax controversy trends at a multi-lateral level
- Enhanced relationship with tax authorities in key jurisdictions

General guidelines for managing TP risks

- Stay connected with global legislative, regulatory and tax administration changes
- Perform regular health checks of the group holding structure, financing arrangements, intangible property ownership and business operational models
- Proper record-keeping and good internal control (system readiness)
- Providing robust support and evidence at the time a transaction is put in place
- Internal stakeholder management and education about transfer pricing risks
- Ensuring consistent TP strategy and approach applied within organization
- Ensuring proper TP documentation and preparation of enhanced or specific supporting documentation on a timely basis to manage the increased risk
- Regular review of TP implementation to ensure outcome aligned with TP approach
- Consider the possibility of negotiating issues upfront with authorities and obtain unilateral, bilateral or multilateral Advance Pricing Agreements (APA)

General guidelines for managing TP controversy

- Understand the tax authorities' concerns
- Take control of the direction of the audit
  - Consistent audit strategy
  - Anticipate nature of queries and be proactive in the presentation of facts and information
  - Reduce unnecessary issues or requests
- Consider strategic involvement of other officials in the process
- Consider audit settlement approach if issue escalates
- Consider the option of mutual agreement procedures (MAP) to resolve disputes and avoid double taxation
- Post dispute resolution, devise strategy and measures to avoid exposure to similar issues for later years and in other countries as well

Information exchange with revenue authorities – Best practices

- Agree with revenue authority exam team regarding requests for information and data
- Discuss any concerns about requests for data and information with revenue authority exam team
- Designated person/team to be responsible for receipt of information and data requests and provision of responses to the revenue authority
- Track receipt of and responses to revenue authority
- Consider carefully area of examination to which information and data relates and anticipate potential substantive tax issues before responding
- Review thoroughly all documents before providing to the revenue authority examination team

Negative outcomes of a poorly managed audit strategy

- Time and resourcing consuming audit process
- Disruption to business operations (e.g. site visits, business interviews)
- Inadvertently provide tax authorities with the more materials to support their investigation
- Danger of broadening the scope of audit investigation into other non-TP aspects (e.g. customs/VAT/PE)
- May lock the organization into a position which is difficult to reverse out of resulting in:
  - Potential risk of higher adjustments and penalties
  - Ongoing exposure for double taxation
- Potential damage to corporate reputation
- Impact to financial and operational performance

Further avenues to manage TP controversy

- Appeals
- Litigation
- MAP
- APA as a proactive alternative or roll-back period
- Arbitration

TP In-house Risk Self-Identification Framework

- I. Identify and Understand the Intercompany Transactions
  - 1. What role and businesses does the entity play in the Group's value chain? Eg is it a hub, a limited risk manufacturer, distributor, treasury centre, etc?
  - 2. Identify all related party transactions - What is the nature, what is the size/volume/frequency of such transactions
  - 3. Examine the Financials carefully and ideally on a segmental basis - Profitability Profile/Trends especially loss making transactions and reasons for such losses.
- II. Country
  - 1. How is the country's transfer pricing legislative framework
    - Does it follows OECD? If not, where are the points of deviation?
    - Has it adopted the BEPS recommendations?
    - What are the significant tribunal or court cases on TP?
  - 2. How is the country's audit environment
    - What are there audit cycles, level of aggressiveness, level of penalty?
    - Has there been audits of industry peers in the country?

TP In-house Risk Self-Identification Framework

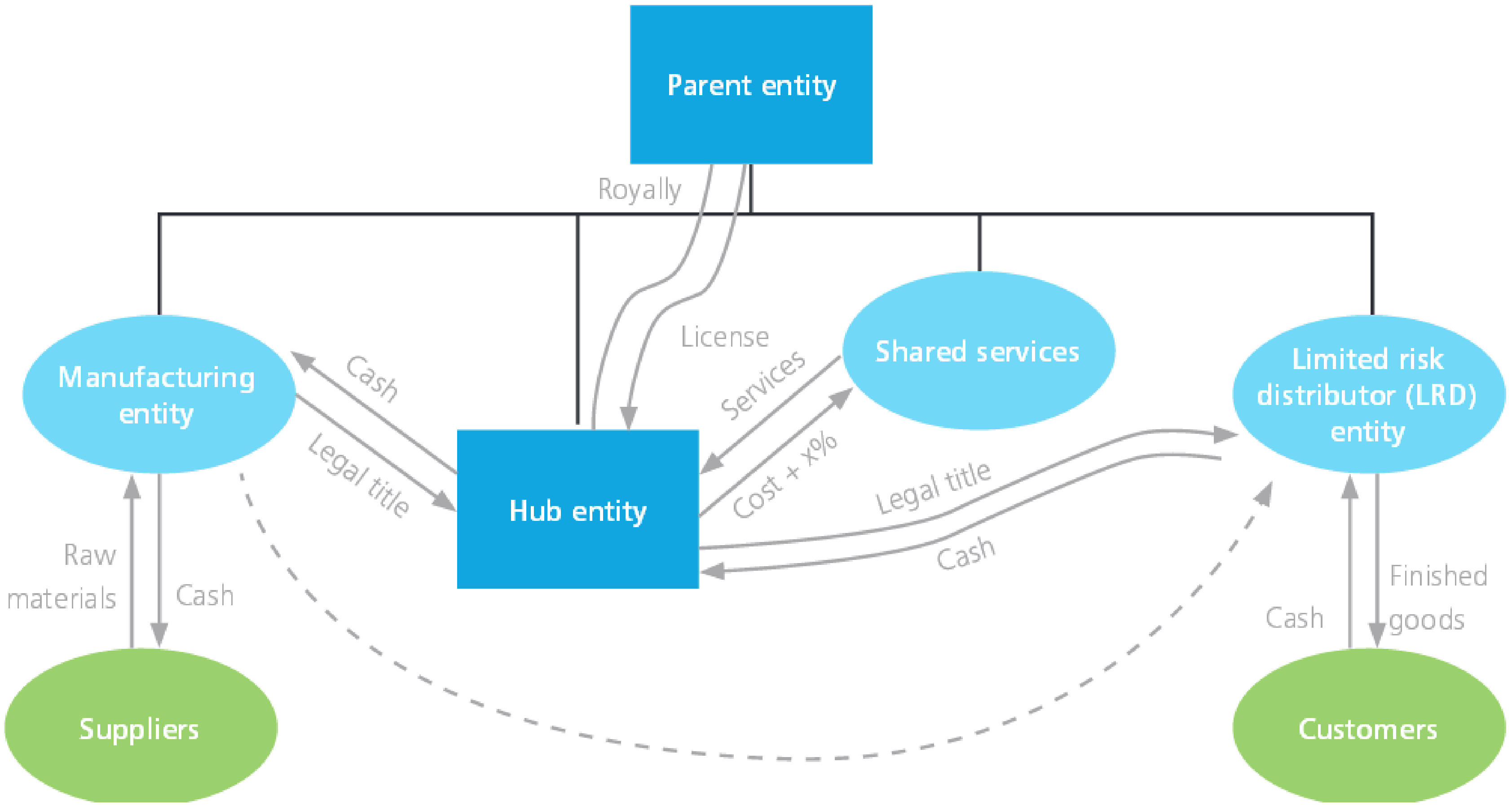
- 3. Audit History of the MNE in that country
  - Has there been audits in the past few years? If so, what transfer pricing issues were raised and for which periods? How were these issues settled or pursued?
- 4. Level of provisioning for transfer pricing (if any)
- 5. Are there other non- transfer pricing factors that impact transfer pricing e.g exchange control, Customs, incentives, VAT.

» III. Compliance Level

- 1. What is the history of compliance with the MNE Group's transfer pricing policies? Has there been deviations from the group's policies?
- 2. What is the level of knowledge and skill and involvement in transfer pricing of
  - the local tax team
  - the local stakeholders such as the CFO or controller.
- 3.What are the TP processes?
  - financial analysts and processes implementing transfer pricing performing calculations, accruals, true-ups
  - are there checks and controls in place for these finance processes?
- 4. Does the country have up-to-date TP documentation, including benchmarking and copies of all major intercompany agreements?

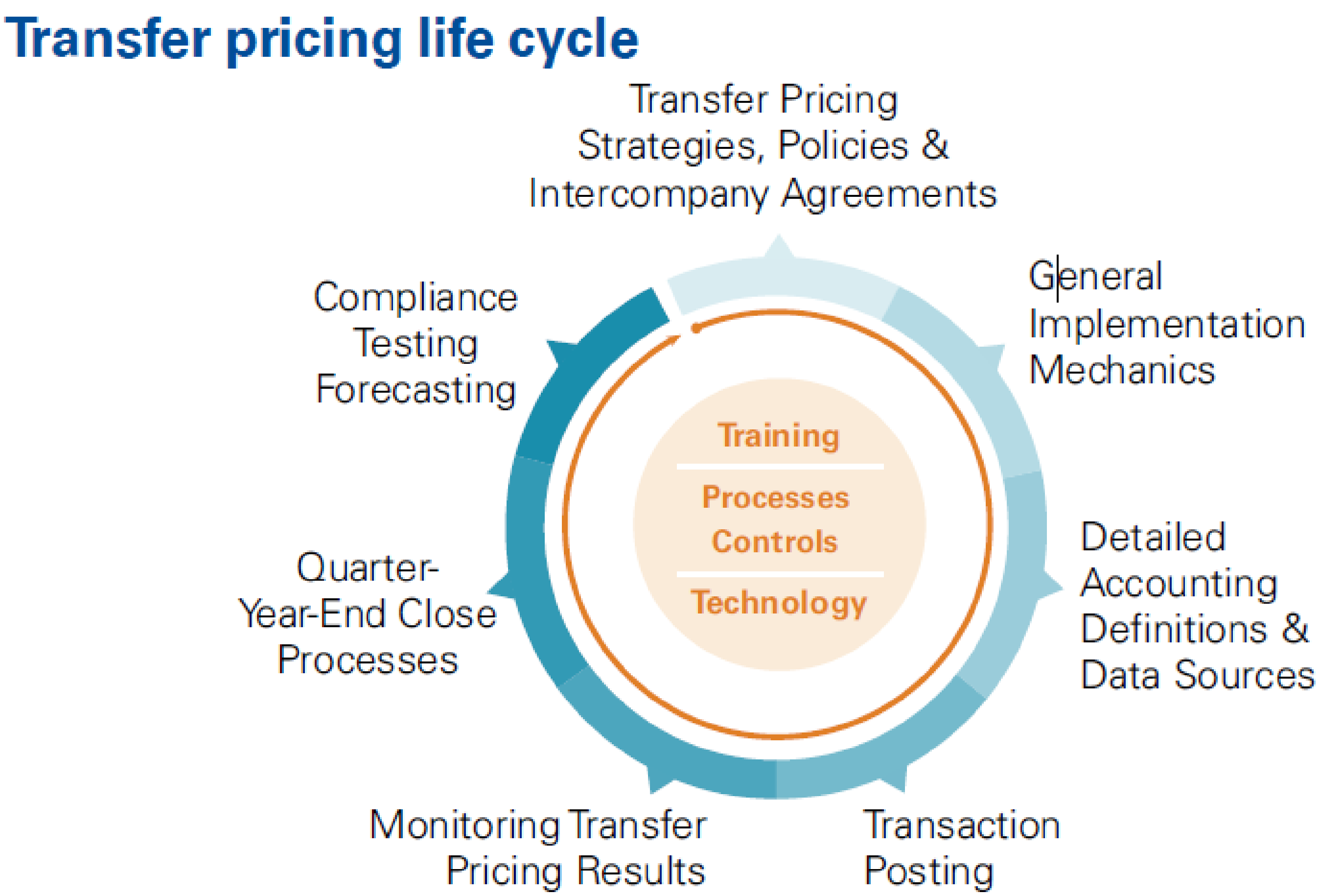
Operational TP Implementation is Key

TP World in More than 2 Dimensions…



Source: https://www2.deloitte.com/content/dam/Deloitte/uk/Documents/tax/deloitte-us-transfer-price-tech.pdf

Operational Aspects of TP

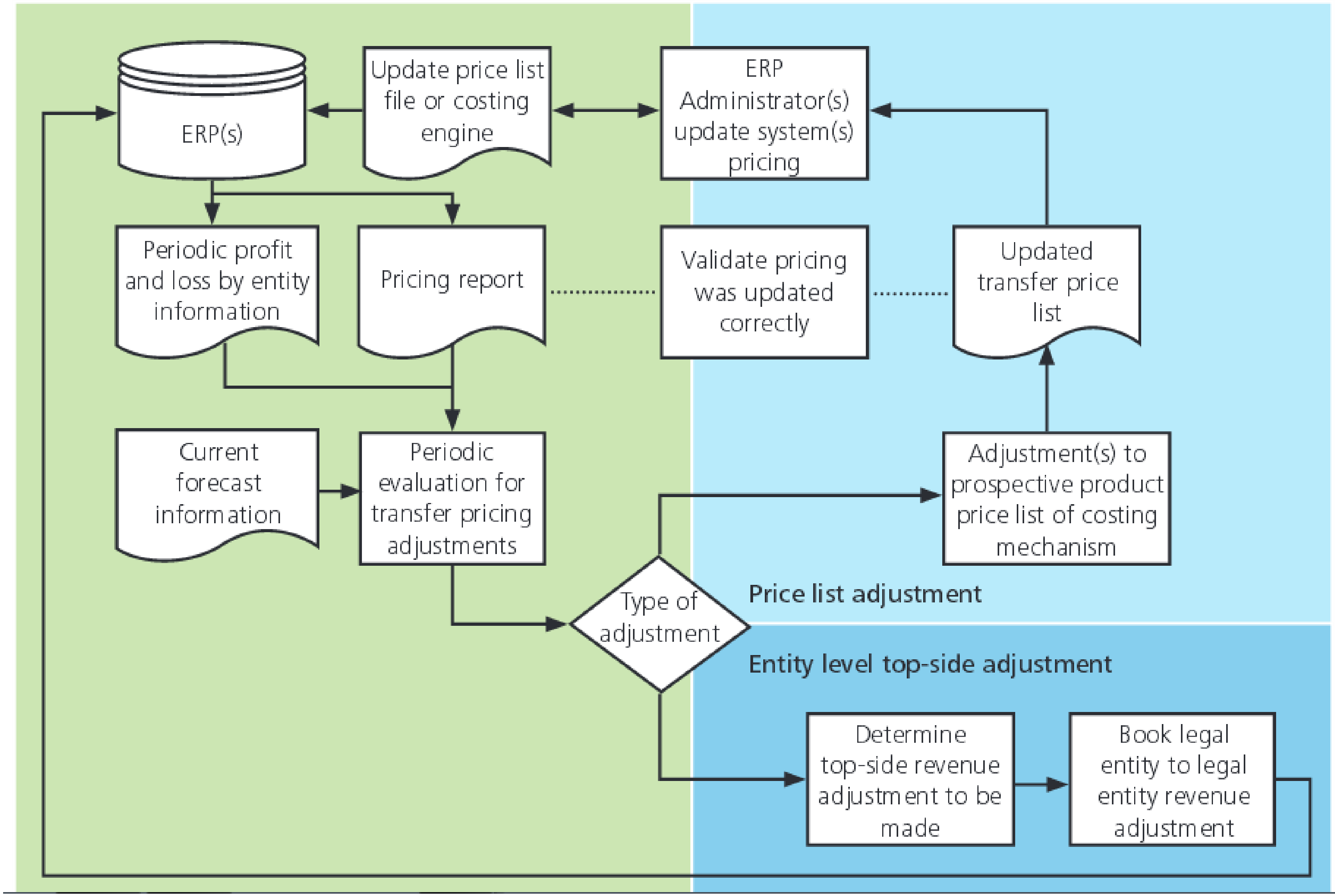


Source: KPMG

Where in the ERP/BI layer are prices held for different pricing methods?

Methods	Calculation	Data	Typically Stored
CPM	Total Costs as fully loaded costs related to the tested transaction	Cost centers with direct, indirect and overhead costs; Applicable mark-up.	Excel based models EPM Data warehouse
PSM	Identification of Total Revenues, Routine Service Fees. Calculation of Residual Profit (Total Revenues reduced by fee for Routine Services) Allocation of the Residual Profit by allocation factors	Revenue Centers by LE; Cost centers of the respective routine service providers by LE; Allocation factors: • Headcount • Revenues • Time sheet • Assets • Other relevant factors	Excel EPM
CUT	Value charged against tested transaction to affiliate against amount charged in a comparable uncontrolled transaction available from public domain	Invoice with charge details raised against affiliate.	Excel Database EPM
RP	Identification of Total Revenues. Calculation of cost of sales – purchase price from related party (Total Revenues reduced by arm's length gross profit)	Revenue Centers by LE.	ERP Excel Data warehouse EPM

Source: PWC



Source: https://www2.deloitte.com/content/dam/Deloitte/uk/Documents/tax/deloitte-us-transfer-price-tech.pdf

TP Only as Good as What Finally Hits the Books…

1. **Problem Areas:**
   - Policy design without regard to implementation
     - Coordinating global team of individuals in multiple departments Differing priorities of each stakeholder in the process
     - Need Country-specific transfer pricing knowledge
   - **Company systems not designed to produce reports for efficient transfer pricing analysis**
   - **ERP complications, multiple systems globally**
   - **Accountability**
   - **Manual processes & true-ups**
   - **Interaction with Accounting, Customs, Regulations and other rules**

Consequences…

2. **Result:**
   - » **Materially misstated financial statements -** entity level reporting
   - » **Regulatory or uncertain tax position reporting/provisioning**
   - » **Lack of sufficient controls around critical process –** out of period adjustments/true-ups
   - » **Increased tax liabilities or audits**
   - » **TP tax penalties**

3. **Investment in Systems: Ford**

Organizational Design and Controls

Organizational Design

1. TP infrastructure and team structure

- Reporting line and incentive alignment/risk appetite
- Finance, Tax, Legal, regional CFO?
- Objective Setting: Tax saves upfront vs Consistency vs Defence. eg Supply Chain optimization
- Alignment to KPI, Global vs regional vs business/product line

2. Governance & Control

- Steering/Governance Committee
- Risk Management or Control Framework
- Across tax, legal and finance functions (info exchange, min disruption)
- Process checks & self-audits
- Clear R&Rs in implementation (Finance v Tax, Group v Country v biz line)

Organizational Design

3. Building a TP Function that is Fit for Purpose

» Team with a variety of skill-sets (ability to influence)

» Optimal mix of house vs external advice (4Cs – Competency, Capacity, Consistency, Convincing)

» Business model and stage of internationalization

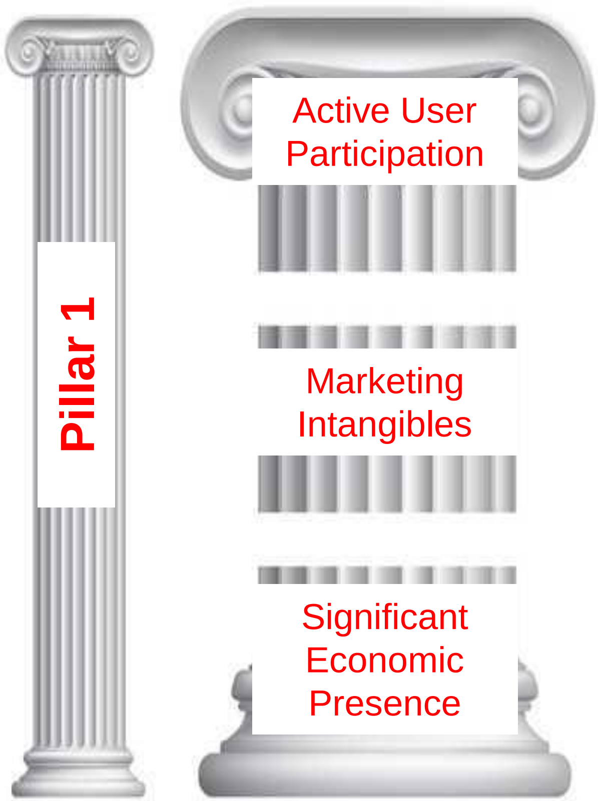
4. Training, Communication & Influence

» Continual investment to embed in Business & Finance – identify ‘change events’, Chapter IX

» Trend towards centralization post-BEPS

Digital Taxation and the Future of TP

OECD Task Force for Digitalised Economy- Twin Pillars 13 Feb 2019



3 policy options for revised profit allocation and nexus rules + 2 measures aimed at tackling remaining BEPS issues, which would effectively amount to a minimum tax of cross-border profits

Pillar 1: Address the broader challenges of the digitalised economy by focusing on the allocation of taxing rights. Businesses to allocate more profits to markets with whom they interact, regardless of the extent of their physical presence there.

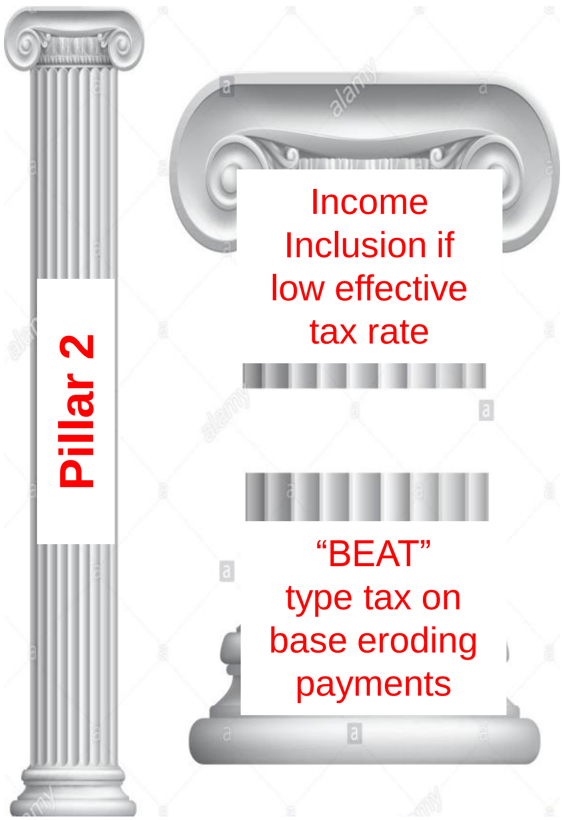
1a. Allocating profits to jurisdictions where “active and participatory user bases” are located, regardless of physical presence

1b. Residual income attributable to marketing intangibles would be allocated to the market jurisdictions based on agreed metrics

1c. “Significant Economic Presence” triggered by “purposeful and sustained interaction” e.g. local user base with data input, local language website, billing in local currency, deriving local digital content, etc

wts global

OECD Task Force for Digitalised Economy- Twin Pillars 13 Feb 2019



Pillar 2: Two measures proposed to go beyond the BEPS reports and further reduce profit shifting to entities with little substance in low-tax jurisdictions:

2a. An "income inclusion rule", whereby income of a foreign branch or controlled entity would be included in the tax base of the controlling taxpayer if that income was subject to an excessively low effective tax rate (with credit granted for any foreign tax paid on such income); and

2b. A "tax on base eroding payments," which would effectively (a) deny the deduction of payments to a related party if that payment was insufficiently taxed beforehand and (b) grant tax treaty benefits only if the beneficiary is "sufficiently taxed" in the other treaty jurisdiction.

BEPS 2.0 or New Digital Initiative?

From BEPS Project 2015

1. Closing Loop Holes
- Respecting Sovereignty to Set Tax Rates

2. BEPS Actions Apply to All

3. Focus on Income Taxation

4. Modify Principles within Existing Framework

- Action 7 refinement to PE boundaries
- BEPS 8-10 updating existing TP Guidelines
- MLI

Review – 2020

Transformation

To Digital Taxation Proposals

1. Reallocating Taxing Rights to Market Countries

- Global Threshold of Minimum Effective Tax

2. Target Subset of Industry: Advertising, Data-User participation, Platforms

3. DST Gross Basis Taxation – losses? Consistency with treaties

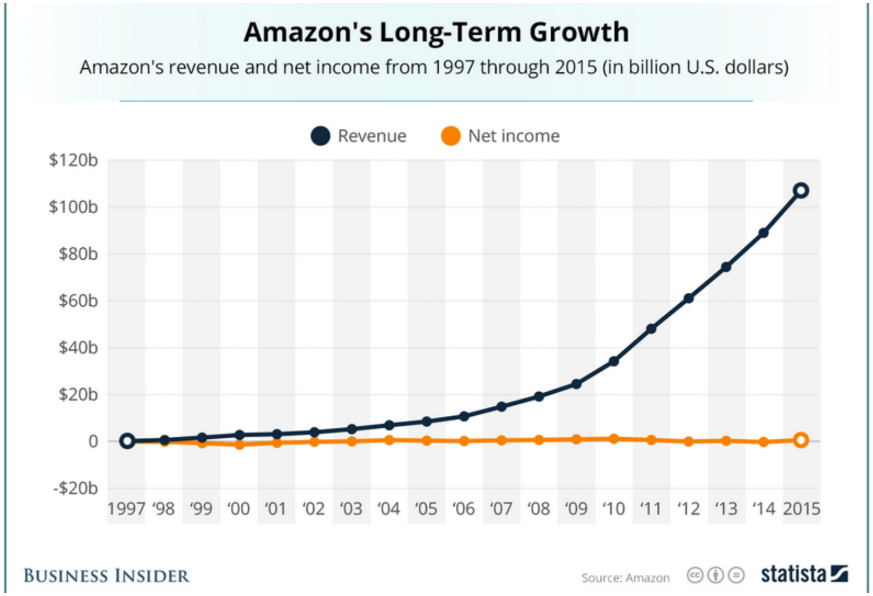
4. New Concepts

- Significant Digital Presence
- Data, User Participation – correlation with value creation?
- Marketing Intangibles
  - Carve out beyond a comparability factor; a special FAR asset?
  - Death of ALP or modified profit split of residual returns?

June 2020 – OECD final recommendations

Profits as Elusive as Unicorns?

Unicorn	Year	Revenue	Profits
Lyft	1H2015	46.7M	-127M
Snapchat	Jan-Nov 2014	3.1M	-128.5M
Uber	2013	104.4M	-56.53M

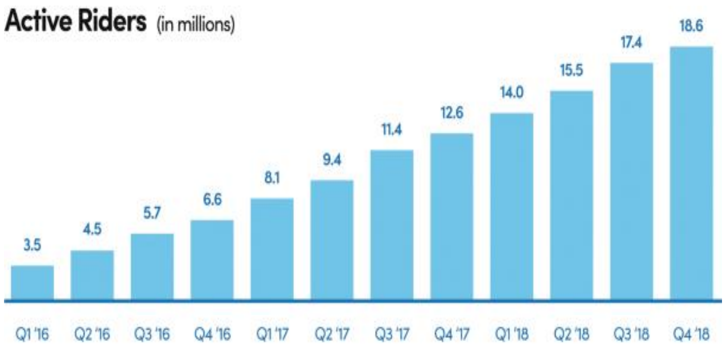


Source: http://www.businessinsider.sg/valley-unicorns-terrified-by-profits-2016-4/?r=US&IR=T; https://www.cbinsights.com/blog/leaked-unicorn-financials/ http://www.businessinsider.sg/amazon-revenue-vs-profit-2016-1/?r=US&IR=T#AYmqxvcQtvDRCM53.97; https://qz.com/1732991/chinas-hurun-list-says-china-has-more-unicorns-than-us/

Value Creation? Lyft IPO Market Cap USD 24bn

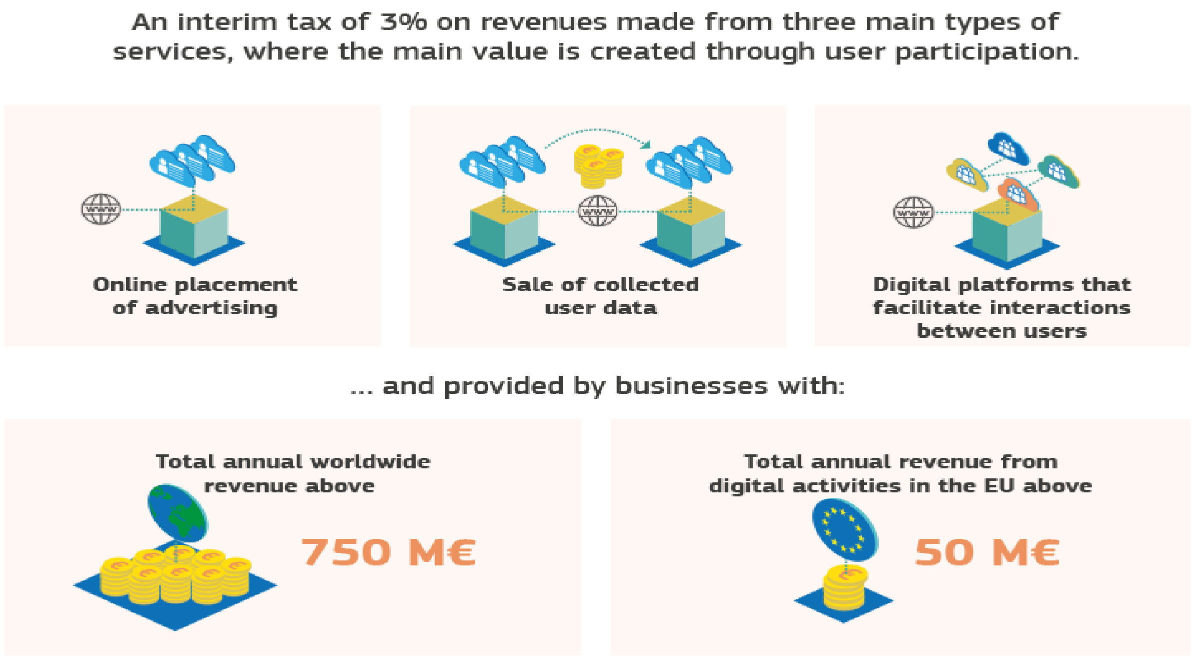
Consolidated Statement of Operations Data

	2016	2017	2018
	Year Ended December 31, (in thousands, except for per share amounts)		
Revenue	$ 343,298	$1,059,881	$2,156,616
Costs and expenses(1)			
Cost of revenue	279,011	659,533	1,243,400
Operations and support	97,880	183,513	338,402
Research and development	64,704	136,646	300,836
Sales and marketing	434,344	567,015	803,751
General and administrative	159,962	221,446	447,938
Total costs and expenses	1,035,901	1,768,153	3,134,327
Loss from operations	(692,603)	(708,272)	(977,711)
Interest income, net	6,964	20,243	66,462
Other income, net	3,246	284	652
Loss before income taxes	(682,393)	(687,745)	(910,597)
Provision for income taxes	401	556	738
Net loss	$ (682,794)	$ (688,301)	$ (911,335)
Net loss per share attributable to common stockholders, basic and diluted(2)	$ (37.08)	$ (35.53)	$ (43.04)
Weighted-average number of shares outstanding used to compute net loss per share attributable to common stockholders, basic and diluted(2)	18,413	19,371	21,176



Source: Lyft FORM S-1 REGISTRATION STATEMENT
https://www.sec.gov/Archives/edgar/data/1759509/000119312519059849/d633517ds1.htm#toc633517_11
https://techcrunch.com/2019/03/28/lyft-prices-ipo-at-top-of-range/

Digital Services Tax an Elixir?



European Parliament In December 2018 amended the DST Directive proposal in such way that online streaming services will now also be in scope of the DST, the EUR 50 million threshold is decreased to EUR 40 million and the 3% rate is amended to 5%. But there is no EU wide consensus.

Can the Digital Economy Be Ring-fenced?

wts global

Category	Companies	
Marketplace - Goods	• Alibaba • Amazon • Apple • Ebay • Google	• Groupon • Rakuten • Schibsted • Wish • Zalando
Marketplace - Services	• Amadeus • Airbnb • Axel Springer • Booking • Expedia • Match.com	• Randstad • Recruit • Sabre • Travelport worldwide • Uber
Digital Advertising	• Amazon • Critéo • Ebay • Facebook	• Google • Microsoft • Twitter • Verizon

Source:https://www.linformaticien.com/actualites/id/51641/taxe-gafa-la-liste-des-29-entreprises-qui-seraient-concernees.aspx

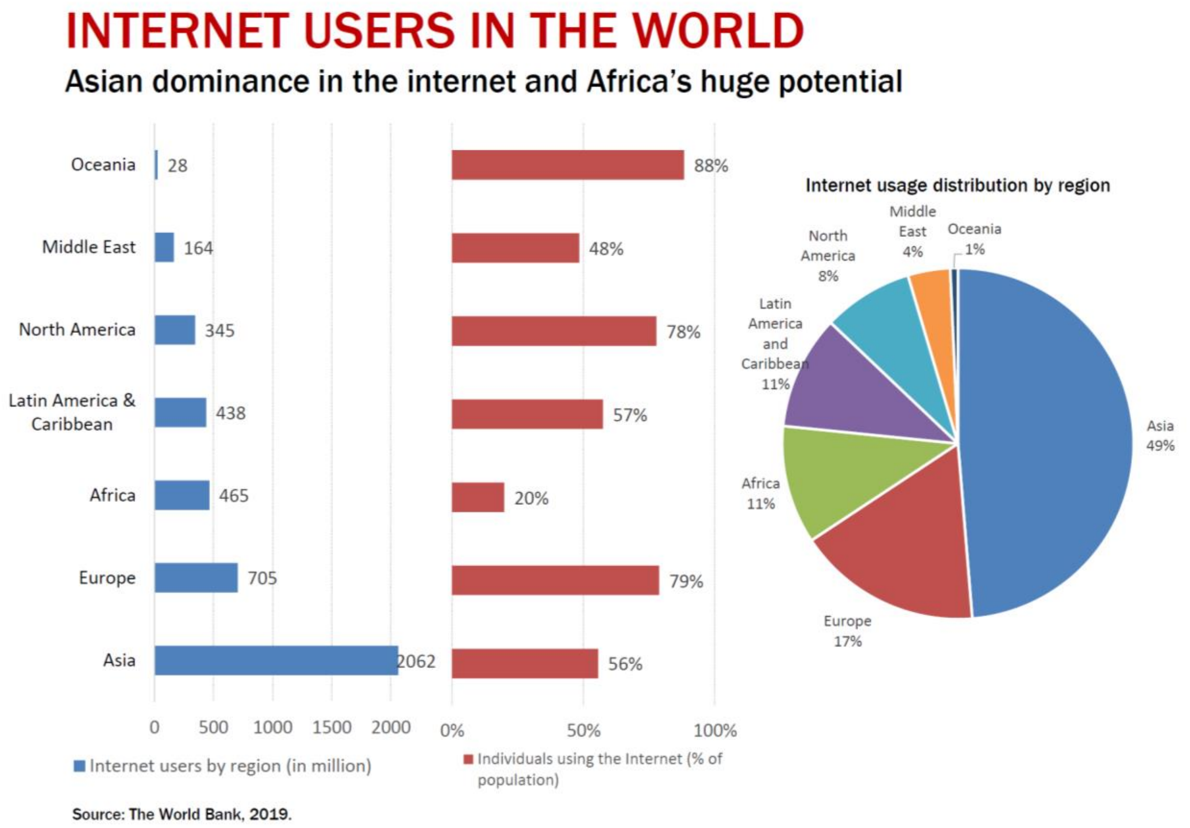
Bill on 6 March to impose a **3% tax on revenues deemed to have been generated in France from 1 Jan 2019** by digital companies where the user is essential for the creation of value.

Threshold
- €25 million supplies in France and €750m worldwide

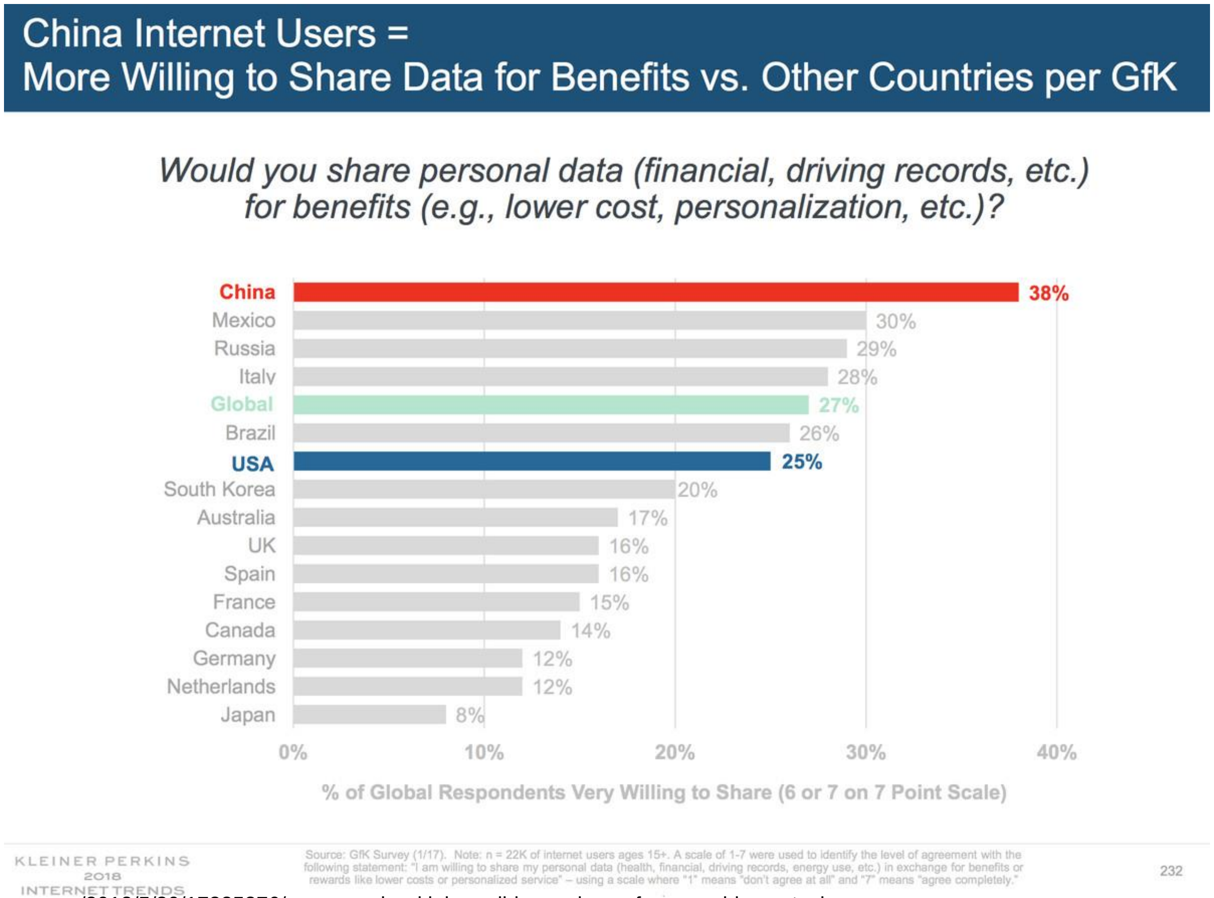
Excluded
- Online sales and the digital provision of digital content for buying and selling would be expressly excluded from the tax
- Start -ups

wts global

New Oil Producers of the Digitalised World…



China with the Lowest “Extraction” Costs?



https://www.vox.com/2018/5/30/17385376/mary-meeker-kleiner-slides-code-conference-chinese-tech

wts global

Tempering the Exuberance – Refining the New 'Oil'

UK Treasury Paper – 'The Economic Value of Data'

a) **Data is 'non-rivalrous' -** single piece of data can be used in multiple algorithms and applications at the same time.
   > means difficult to establish the rights to use, exclude and transfer data.

b) **Data can generate positive externalities** - While data can reveal new findings and insights if it is aggregated, linked and analysed, the benefits might not be directly foreseeable and may not always accrue to the data creator or controller. As a result, valuable data may be under-exploited or under-share

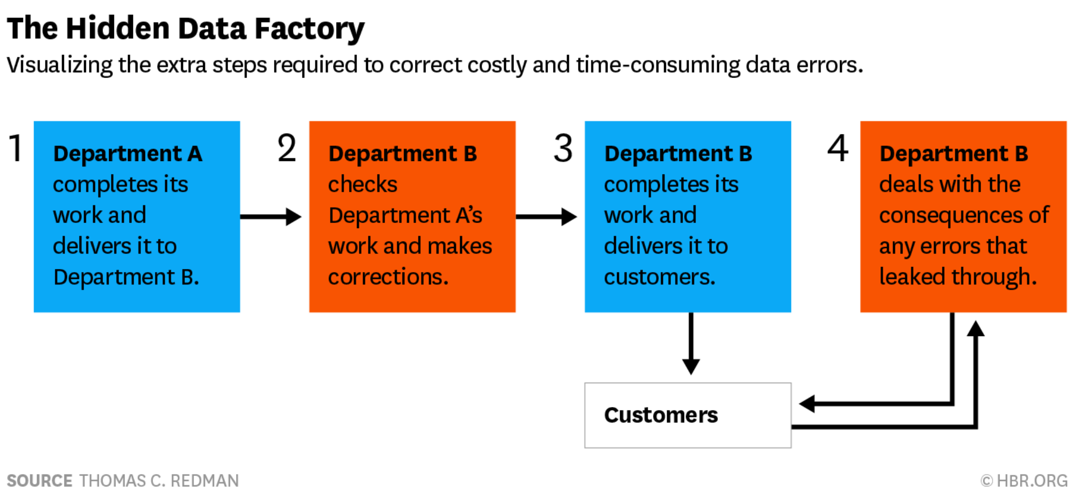
c) **Data exhibits economies of scope** - Merging two complementary datasets may produce more insight than keeping them separate. Means that the potential value of data may not always be foreseeable to the data controller

Data Curation a DEMPE function?

Harvard Business Review/IBM: **Bad/poor quality data cost an $3.1 trillion yearly** in the US (2016)

50% —time that knowledge workers waste in hidden data factories, hunting for data, finding and correcting errors, and searching for confirmatory sources for data they don't trust.

60% —time that data scientists spend cleaning and organizing data



Source:
https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/731349/20180730_HMT_Discussion_Paper_-_The_Economic_Value_of_Data.pdf
https://hbr.org/2016/09/bad-data-costs-the-u-s-3-trillion-per-year

In Asia - Markets Have Already Spoken…

OECD Actions 8-10					
Development	Enhancement	Maintenance	Protection	Exploitation	
Ok to Outsource provided maintain Control, Management, decisions, ability to bear risks					
Residence	Residence	Residence	Residence	Source	
China					
Development	Enhancement	Maintenance	Protection	Exploitation	Promotion
De-emphasizes control, no mention of decision making, management of development budget, IP legal defense, instead emphasizes adaptation to local, market research, maintain customer relations, enable mass production, trial production, establish marketing channels, CRM and brand promotion					
Residence/S	Residence/S	Residence/S	Residence/S	Source	Source
India					
Development	Enhancement	Maintenance	Protection	Exploitation	AMP
Local Marketing Intangibles					

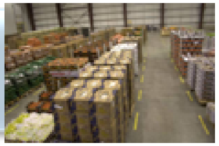
Location Savings & Market Premium

Locations Savings - China

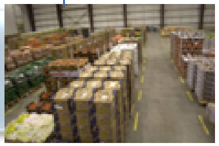
China | Country B | Country C

A Sub
R&D 1

B Sub
R&D 2



C Sub
R&D 3



	China (A Sub)		Country B (B Sub)		Country C (C Sub)
Output Units	5	Output Units	5	Output Units	15
Labour	$50	Labour	$150	Labour	$220
Raw materials	$30	Raw materials	$50	Raw materials	$100
Land and rent	$20	Land and rent	$25	Land and rent	$55
Cost base for 5 units	$100	Cost per output unit	$225/5= $45	Cost per output unit	$375/15= $25
Cost per output unit	$100/5= $20				

compare

Average cost per output unit $600/20 = $30
Average cost base for 5 units = $150

Median = Cost + 8%

Country D

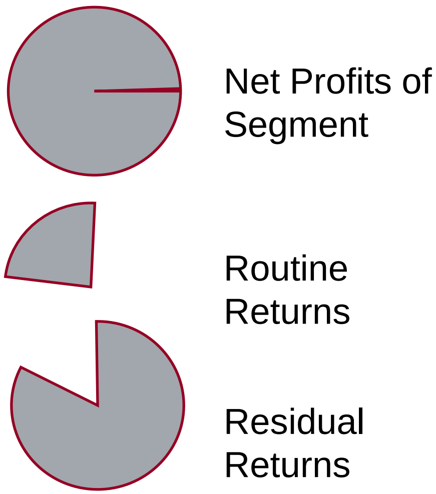
D Sub
Regional Hub

Difference in cost base
(China vs foreign average) $150-$100 = $50
Difference X mark-up $50*8% = $4
Additional profit to China for location savings = $4
Arm's length profit for China = $4 + $100*8% = $12
Arm's length mark-up for China = $12/Cost base of $100 = 12%

Source: China country submission, UN Transfer Pricing Manual

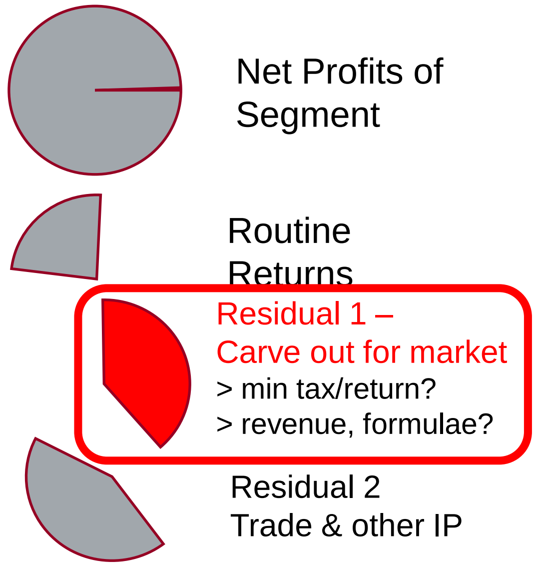
Asia in a Digital BEPS 2.0 Era

OECD Post BEPS



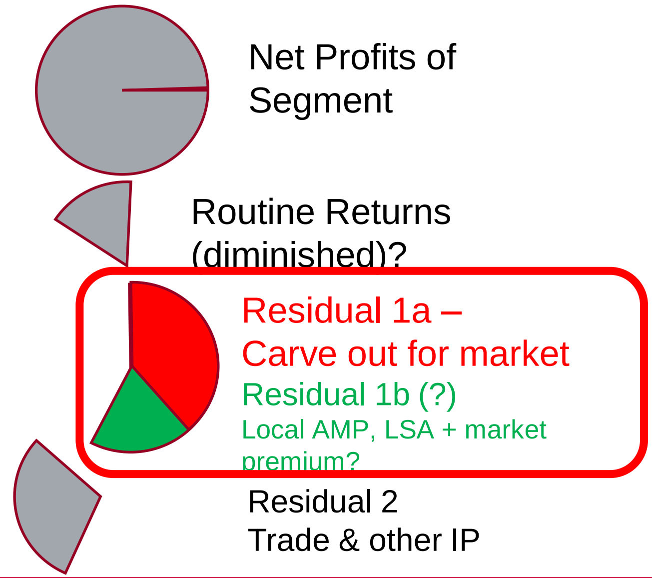
Allocation of Profits						
Functions	D	E	M	P	E	
Assets	Brand, Trade IP					
Risks	R&D, etc					

Digital Tax Unified Approach



Allocation of Profits					
Functions	D	E	M	P	E
Assets	Non-Market IP				
Risks	R&D, etc				

Emerging Asia(?)



Allocation of Profits						
Functions	D	E	M	P	E	P, AMP
Assets	Non-Market IP; LSA + Market Premium (?)					
Risks	R&D, local prototype testing, roll-out?					

wts global

Unified Approach vs Fractional Apportionment

OECD “Unified Approach”

Total Operating Profit (A1)

Issue: overlap btw A, C and Local AMP, Location Savings

Fixed % routine functions (A2)
Marketing & distribution – B*

Binding & effective dispute resolution (C*)

‘New taxing right’ of residual ex-trade, capital & risk to market via formulae (A3&4 – no physical presence) or C* - ALP for functions beyond mkt &distri

Rest of Residual returns Trade, capital & risk other IP

Allocation of Profits

Functions	D	E	M	P	E	AMP
Assets	Non-Market IP; Location savings					
Risks	R&D, local prototype testing, roll-out?					

Article 7 – Fractional Apportionment

Net Profits

Higher of:
(i) Indian revenue x global EBITA margin; or
(ii) 2% India revenue

Deemed India derived profits to be multiplied by a multiplying factor (weighted by sales, assets, employees and users) in order to determine the profits attributable to the operations of PE in India

Weights across categories

Types of business models	Sales	Employees		Assets	Users
		Manpower	Wages		
(a) Non-digital business models	1/3	1/6	1/6	1/3	N.A.
(b) Digital models with low/ medium user intensity	0.3	0.15	0.15	0.3	0.1
(c) Digital models with high user intensity	0.3	0.125	0.125	0.25	0.2

How Could Asia "Digital BEPS 2.0" World Look Like for Taxpayers?

Indirect, no treaty double tax relief

Malaysia DST

Destination VAT, overseas vendor registration (JPN, SG, etc)

Traditional Bricks & Mortar

Traditional with online sales channel

Pure Digital

Income tax, treaty

New Treaty provision - Digital PE based on sales (India), server PE (Korea, India)

Unified Approach New Taxing Right + location savings, AMP

HR and other systems

Accounting & Finance ERP

Payments/ Invoicing/ Fulfilment

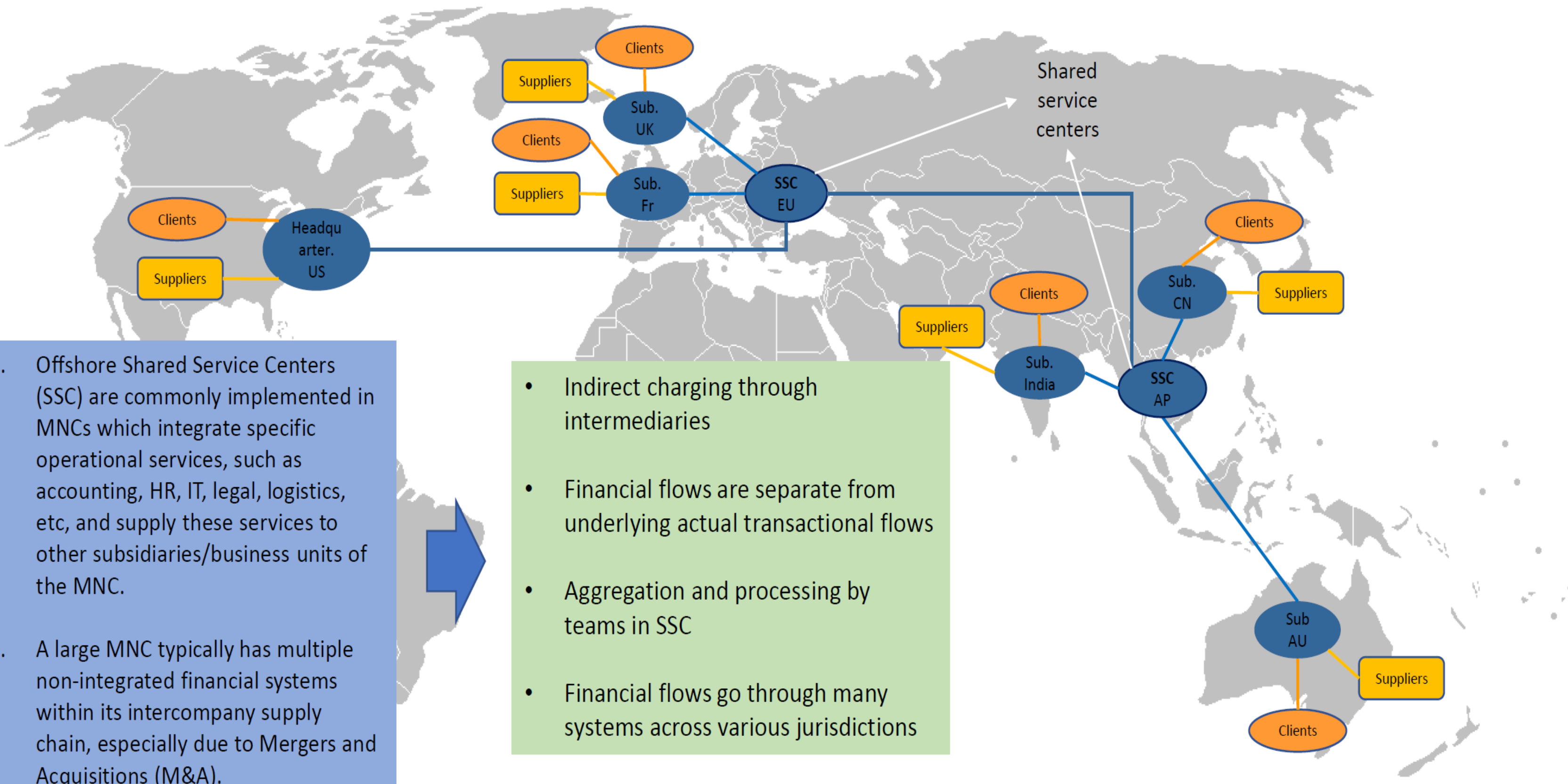
CRM/Sales

Analytics, Data capture

1. Tracking users (data capture) vs customers (sales)
2. Data privacy across units and countries
3. Segmentation of financials and application of tax rules

Digitalization of TP Function

Current State of MNE’s Intercompany Transactions



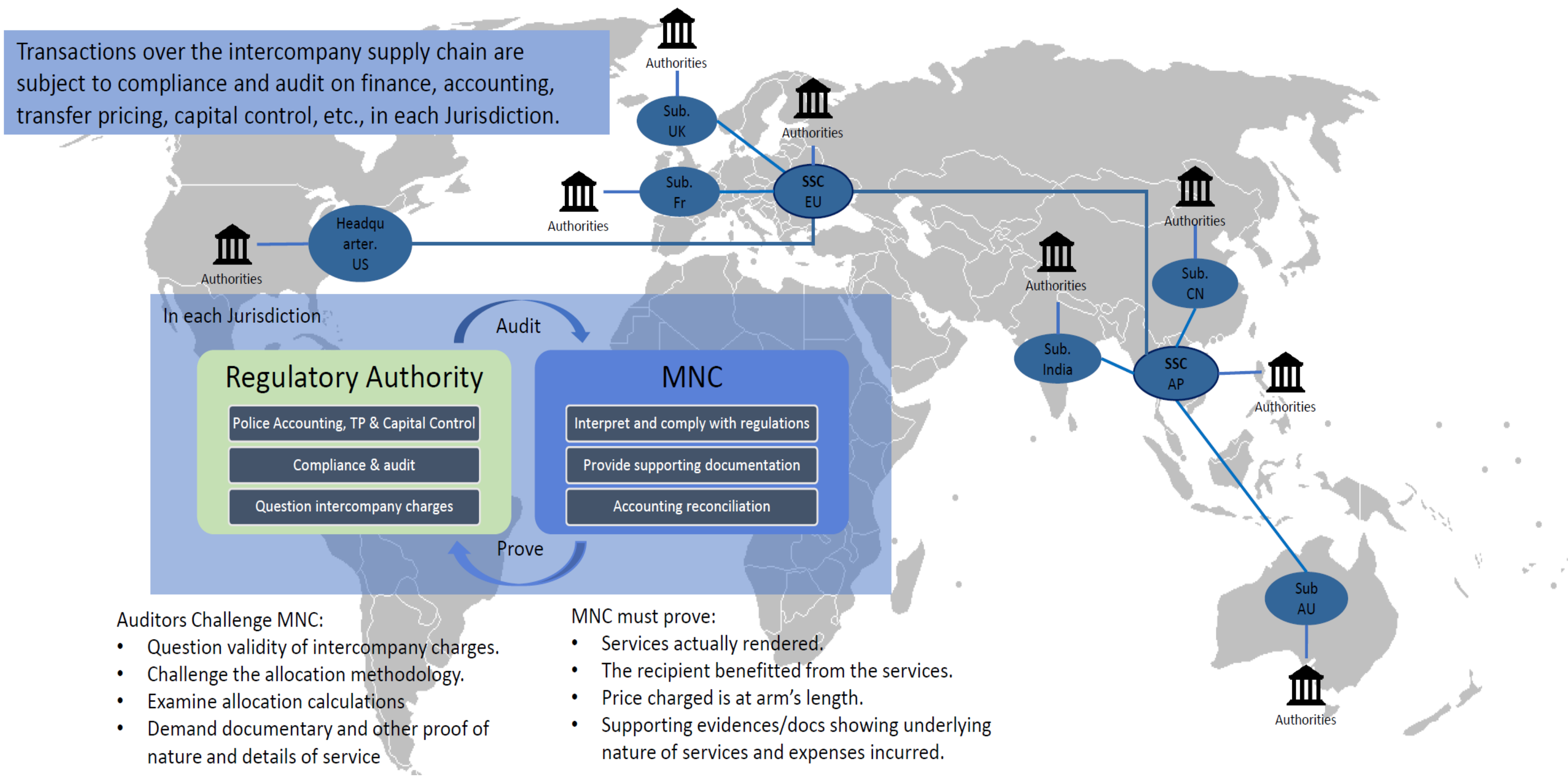
1. Offshore Shared Service Centers (SSC) are commonly implemented in MNCs which integrate specific operational services, such as accounting, HR, IT, legal, logistics, etc, and supply these services to other subsidiaries/business units of the MNC.

2. A large MNC typically has multiple non-integrated financial systems within its intercompany supply chain, especially due to Mergers and Acquisitions (M&A).

- Indirect charging through intermediaries
- Financial flows are separate from underlying actual transactional flows
- Aggregation and processing by teams in SSC
- Financial flows go through many systems across various jurisdictions

Source: IBM Research, Whitepaper Blockchain/DLT: A Game-Changer in Managing Multinational Corporations’ Intercompany Transactions?

MNEs Facing Multi-jurisdictional Compliance & Audit



Auditors Challenge MNC:

- Question validity of intercompany charges.
- Challenge the allocation methodology.
- Examine allocation calculations
- Demand documentary and other proof of nature and details of service

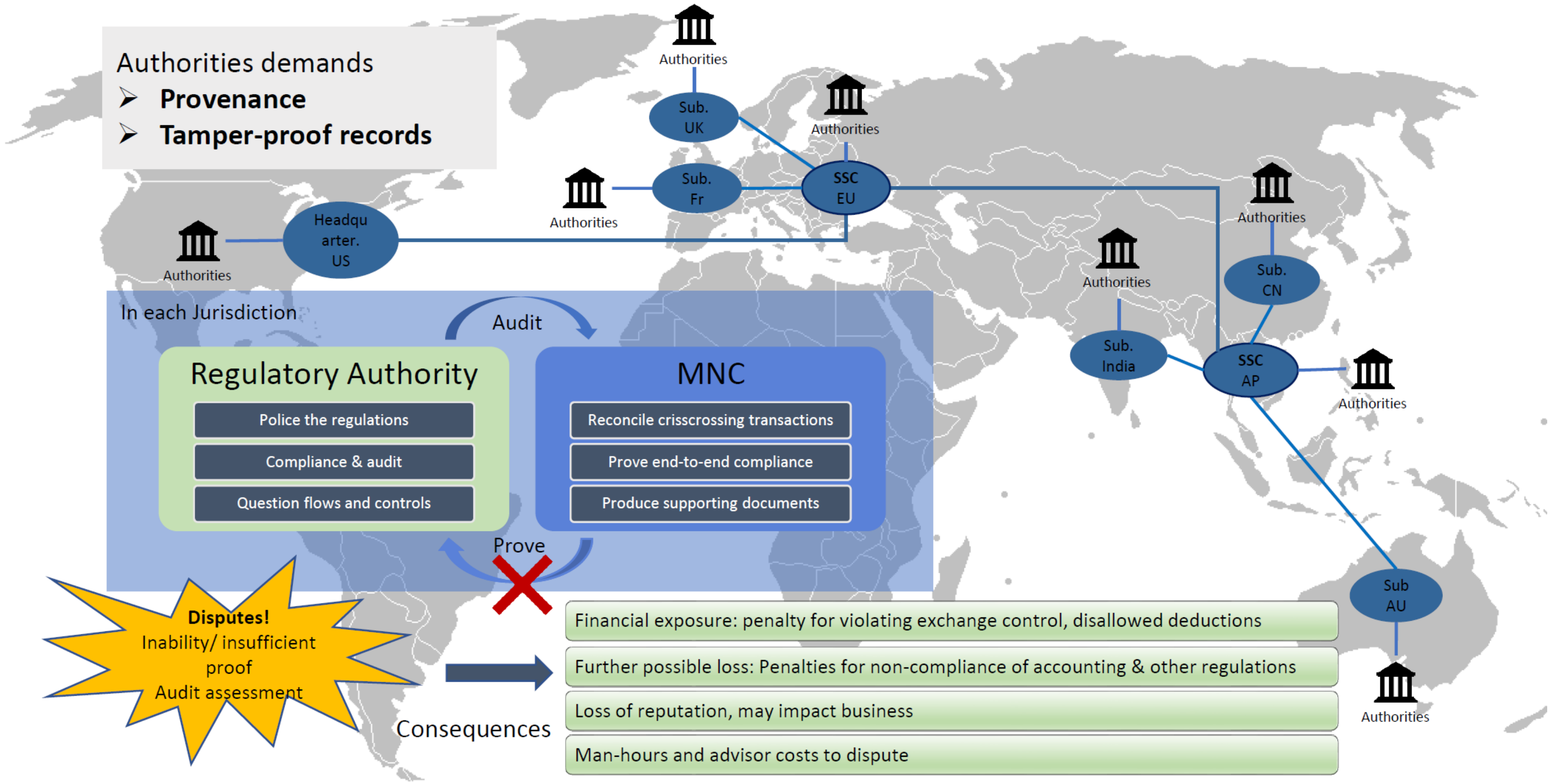
MNC must prove:

- Services actually rendered.
- The recipient benefitted from the services.
- Price charged is at arm's length.
- Supporting evidences/docs showing underlying nature of services and expenses incurred.

Source: IBM Research, Whitepaper Blockchain/DLT: A Game-Changer in Managing Multinational Corporations' Intercompany Transactions?

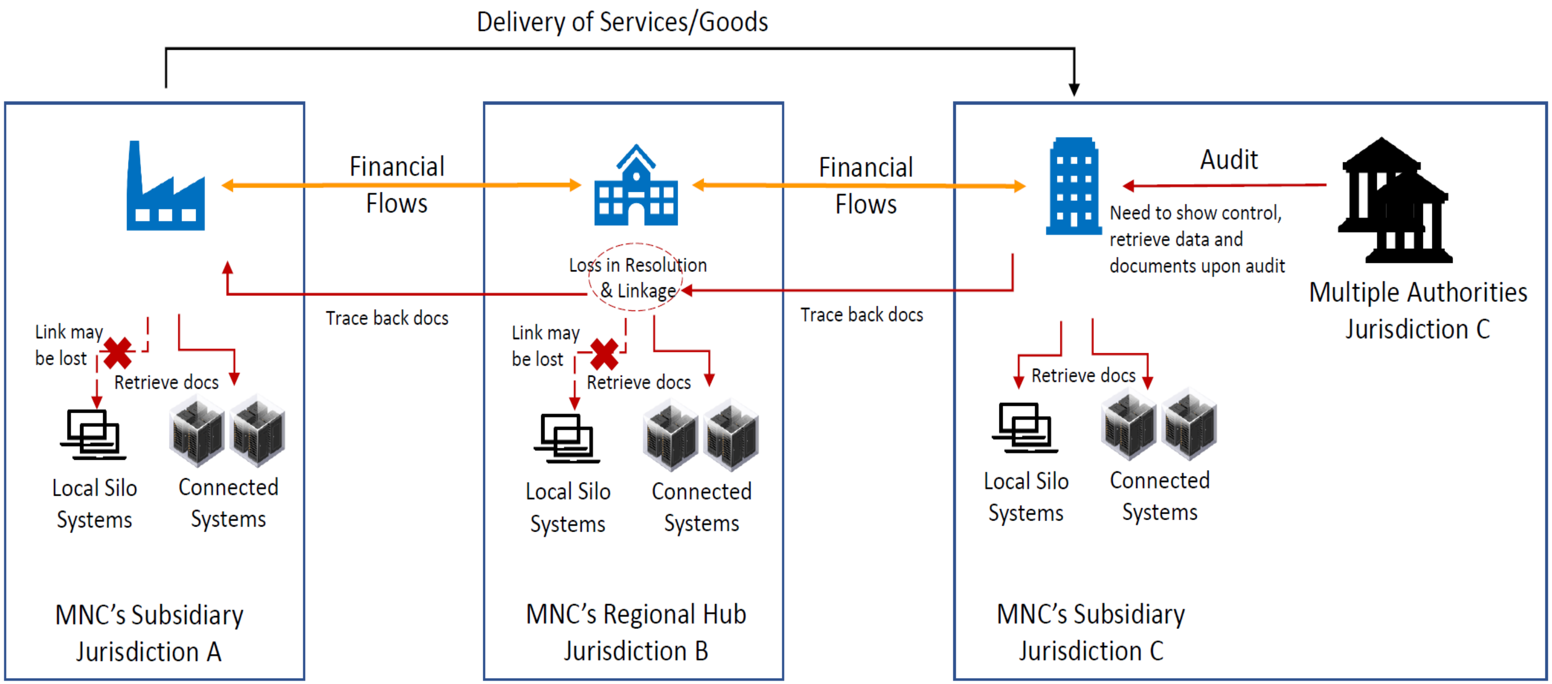
Operational Transfer Pricing Issues

Loss of Provenance → Audit Disputes → Risk Exposure



Source: IBM Research, Whitepaper Blockchain/DLT: A Game-Changer in Managing Multinational Corporations' Intercompany Transactions?

The Challenge at a Transactional Level



Loss of Data Resolution and Linkage in Process, Causing Problems When Being Audited

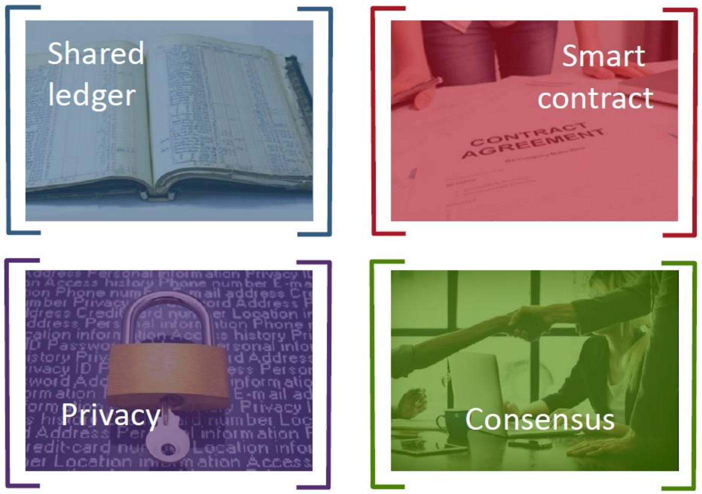
Source: IBM Research, Whitepaper Blockchain/DLT: A Game-Changer in Managing Multinational Corporations' Intercompany Transactions?

Blockchain & Distributed Ledger Technology

Blockchain/DLT is an emerging platform for transaction services that will fundamentally change and reimagine the way we do business.

Append-only distributed system of record shared across business network

Business terms embedded in transaction database & executed with transactions



Ensuring appropriate visibility; transactions are secure, authenticated & verifiable

All parties agree to network verified transaction

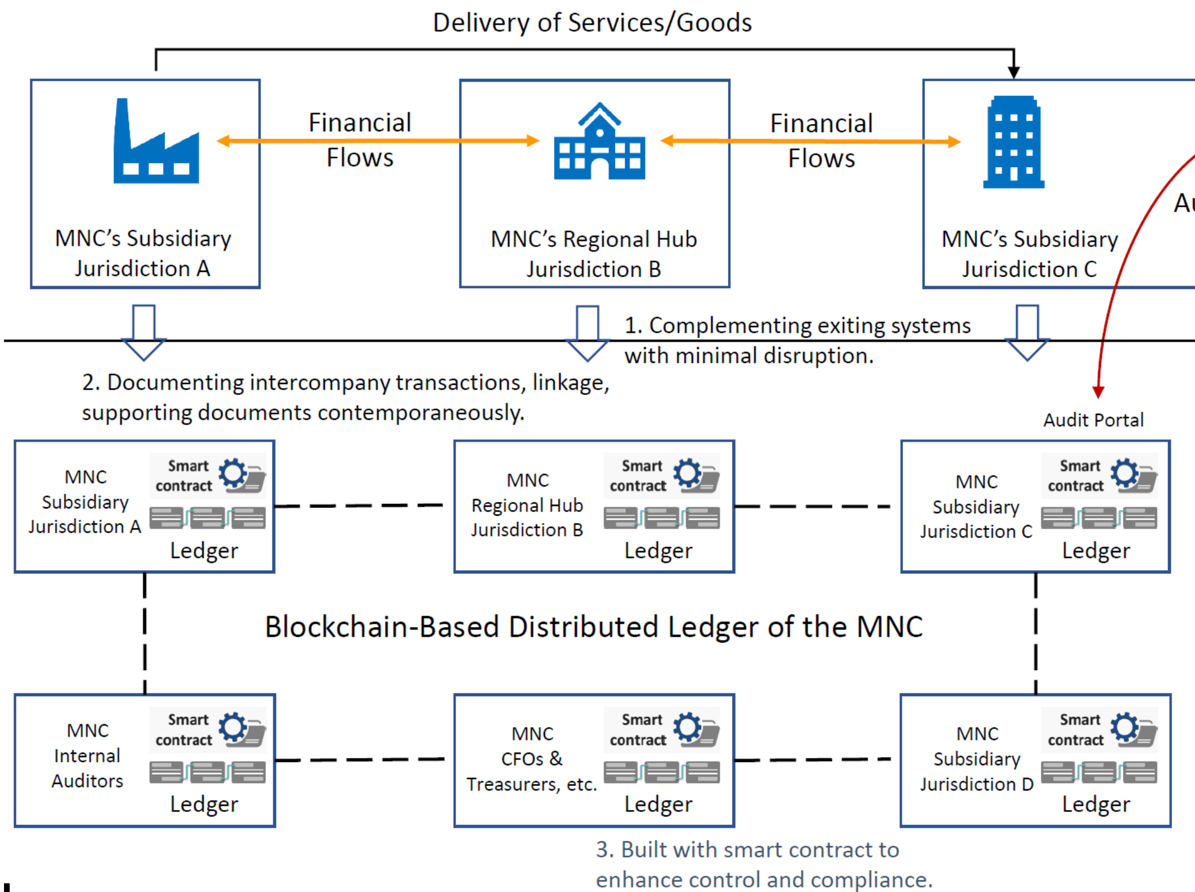
Provenance/Traceability Immutability/Finality

Increased Efficiency Lower Cost

IBM Research | IBM Center for Blockchain Innovation

Source: IBM Research, Whitepaper Blockchain/DLT: A Game-Changer in Managing Multinational Corporations' Intercompany Transactions?

Blockchain Based Approach



An illustration of MNC's Intercompany Blockchain

Benefits

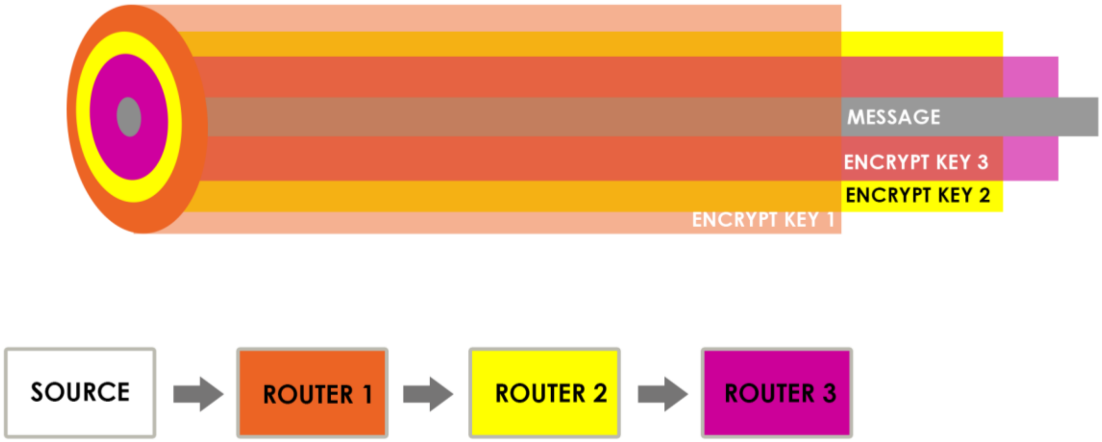
I. End-to-end traceability & tamper-proof documentation for external auditing.
II. End-to-end visibility with resolution preserved for CFOs, Treasurers, & Internal Auditors, etc.

Blockchain won't do anything, won't prevent audit from happening. But can help MNC when being audited.

Source: IBM Research, Whitepaper Blockchain/DLT: A Game-Changer in Managing Multinational Corporations' Intercompany Transactions?

Pealing the Layered Onion - Future Possibilities with Cryptography

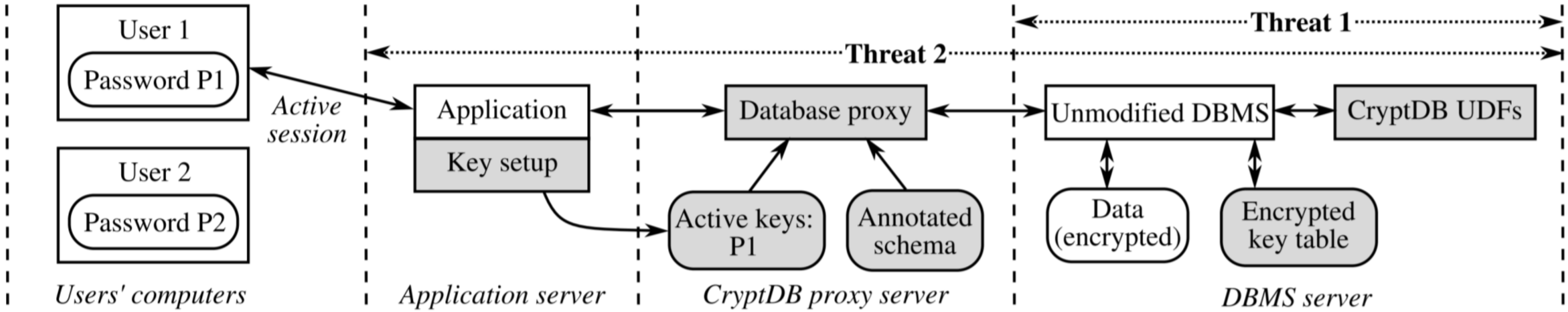
Onion Routing and Encryption



1. Onion - data structure formed by "wrapping" a message with successive layers of encryption to be decrypted ("peeled" or "unwrapped") by as many intermediary computers as there are layers before arriving at its destination
2. Source of the data sends the 'Onion' to Router 1, which removes a layer of encryption to learn only where to send it next and where it came from (though it does not know if the sender is the origin or just another node). Router 1 sends it to Router 2, which decrypts another layer to learn its next destination. Router 2 sends it to Router 3, which removes the final layer of encryption and transmits the original message to its destination.

Source: https://www.pinterest.com/pin/324540716880362314/?lp=true, https://en.wikipedia.org/wiki/Onion_routing#/media/File:Onion_diagram.svg

MIT CSAIL CryptDB Architecture



1. Two parts to CryptDB's architecture: a database proxy and an unmodified Database Management Systems (DBMS). CryptDB uses user-defined functions (UDFs) to perform cryptographic operations in the DBMS. Rectangular and rounded boxes represent processes and data, respectively.
2. Shading indicates components added by CryptDB. Dashed lines indicate separation between users' computers, the application server, a server running CryptDB's database proxy (which is usually the same as the application server), and the DBMS server.
3. Two kinds of threats in dotted lines.
   a. Threat 1, a **curious database administrator** with complete access to the DBMS server snoops on private data, in which case CryptDB prevents the DBA from accessing any private information.
   b. Threat 2, an **adversary gains complete control** over both the software and hardware of the application, proxy, and DBMS servers, in which case CryptDB ensures the adversary cannot obtain data belonging to users that are not logged in (e.g., user 2).

Source: https://people.csail.mit.edu/nickolai/papers/raluca-cryptdb.pdf

Potential Application to Taxation

1. Process SQL queries on encrypted data
2. Allows hiding of database from database administrators; database to be put in the Cloud
3. Modest throughput loss, No changes to DBMS and No change to applications

Potential Uses

1. Protecting sensitive Cross Border Tax Information Exchanged

   - Common Reporting Standard and Country-by-Country Reporting

   - Central/Federal to local transmission and vice-versa

     a. Protecting data integrity during transmission and data-at-rest/end point security
     b. Limiting data use to intended party and intended purpose- limited through User Defined Functions

2. Blockchain coin for intercompany settlements

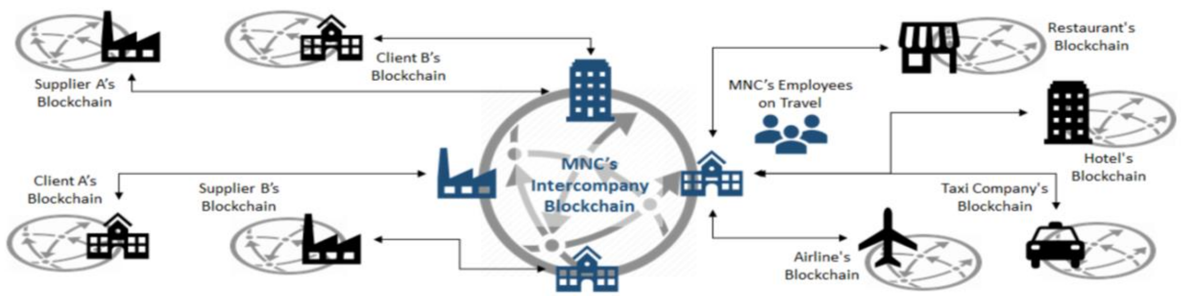
   a. Faster than RTGS, transfer via wallets then clear through T+1 or T+2 via RTGS
   b. Netting off possibilities but query: Dealing with compliance with Foreign Exchange Control regime?

Caveats

1. Does not solve basic issues such as incomplete or erroneous data. This may mean having controls and securing off chain transactions.
2. Return on Investment not always clear (cheaper to offshore/outsource?)
3. Once written, errors are also captured indeliably
4. Compatibility between different initiatives
5. Future – quantum computing may break cryptography?

Glimpse Into the Future

Future: Connected Networks of Enterprises' Blockchains



Source: IBM Research, Whitepaper Blockchain/DLT: A Game-Changer in Managing Multinational Corporations' Intercompany Transactions?

MNC's Intercompany Blockchain is a good starting point.

1. Co-operative Compliance
2. Libra and Central bank issued Cryptocurrencies
3. Restoration of the Arm's Length Principle ? micro-transaction data yields CUPs, overcome lack of comparables = restoration of pure arm's length principle

Questions?

MAPs

- When a taxpayer suffers a TP adjustment in one jurisdiction, it can choose to invoke the MAP Article of the tax treaty between the jurisdiction and the counterparty jurisdiction.
- Taxpayers must be careful of time limits stated in MAP Article and domestic provisions on objections or domestic recourse
- *Article 24(1):*
  "Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Agreement, he may, irrespective of the remedies provided by the domestic law of those Contracting States, present his case to the competent authority of the Contracting State of which he is a resident. The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the Agreement."

MAPs (con't)

- Competent authorities (usually the tax authorities) of both jurisdictions are then obliged under the tax treaty to enter into discussion on the arm's length outcome of the related party transaction, effectively eliminating double taxation.
- Many MAPs translate into APAs for future years – providing taxpayers and tax authorities tax certainty.
- Time taken for MAP applications to be resolved may vary significantly across different tax jurisdictions, based on complexity of transaction and tax authorities involved.
- As part of the minimum standard on treaty-based dispute resolution to which all OECD BEPS and G20 countries have agreed to adhere to, compliance with the standard will be subject to peer based monitoring that will be executed through the Forum on Tax Administration's MAP Forum.

General MAP process

- Notification of intention to make MAP request to respective tax authorities
  - Notification of intention must be within the time limit specified in the MAP Article of the relevant Double Taxation Agreement (DTA)
- Preliminary meetings to be conducted by respective tax authorities
  - Taxpayer to explain circumstances leading to TP adjustments and actions taken by the related parties and competent authorities in other jurisdictions
  - The tax authorities evaluate situation and grounds for request, including quality and adequacy of taxpayer's documentation
- Formal submission of MAP request
- Review and resolution of double taxation (Competent Authorities to conduct discussions)
- Post-agreement debrief and execution of agreement

APA

» An APA is an agreement between a tax authority and a taxpayer, or between tax authorities, where the tax authorities pre-approve a TP methodology and the related pricing of a specified related party transaction.

» An APA can either be unilateral (only one tax authority involved), bilateral (two tax authorities involved) or multilateral (several tax authorities involved).

» A TP study being part of an APA formal submission provides the required support for the pre-approved methodology and related pricing.

» The APA is valid for a time period, and may be renewed.

» In Singapore, the APA period is typically five years with the roll-back of BAPA to prior years (typically up to two prior years although a longer period may be considered) to be decided by the IRAS on a case-by-case basis subject to agreement with the counterpart Competent Authority.

APA (con't)

» Post-BEPS, APAs continue to gain acceptance by many taxpayers around the region. New or emerging APA programmes in India, Indonesia, Malaysia, Vietnam.

» APAs can involve both small and large taxpayers. APAs can address both simple (e.g., limited risk distribution) and complex arrangements (e.g., business restructuring).

» APA process can encompass broader aspects of income tax issues associated with covered transactions.

» APAs provide certainty to taxpayer of its transfer pricing affairs for a period of the agreed timeframe – and often the renewal process is much more straightforward, assuming no change to the underlying business and functionality of the taxpayer

» Overall, APAs can be an effective and proactive approach to managing a taxpayer's transfer pricing risks.

Benefits of APAs

Tax certainty

- Provides certainty to taxpayers with respect to its transfer pricing affairs

Proactive approach

- Is a proactive approach with the tax authorities
- May also ensure that the discussion is conducted at the 'right level'

Benefits

Solution to complex TP issues

- May be seen as a long-term and collaborative solution to complex cross-broader matters

Costs

- Potentially reduce the long-term compliance costs for taxpayers, factoring in audit and controversy management

wts global

Costs of APAs

Costs

Timeliness

- » Time-consuming exercise, particularly in a bilateral or multi-lateral context, often going beyond 2 years from the time of APA application

Resource intensive

- » May require significant upfront resource investment by both taxpayers and tax authorities

Information disclosure

- » Proactive approach also result in additional and detailed information disclosure to tax authorities in advance

Success

- » No guarantee of a successful conclusion
- » May not provide certainty if critical assumptions are breached or business restructuring occurs


Thank you

Gazing into the Crystal Ball

Financial Services & Tech – Never the Twain Shall Meet?

	Financial Services – Attribution of Profits to PE 2010	BEPS Actions 8-10
Functions	Significant People's Function (SPF), Key Entrepreneurial Risk-Taking Functions (KERT)	Development, Enhancement, Maintenance, Protection and Exploitation (DEMPE)
Assets (issue of mobile intangibles)	Capital	Intellectual Property
Risks	Manage risks + financial capacity to assume losses	Manage & Control risks + financial capacity to assume losses
What is appropriate return to capital?	Authorised OECD Approach – KERT in PE ➡ assume risk ➡ capital needed against the risk	Risk weighted return Risk-free return
Allocation/Attribution of Income	Attribution of Profits to PE Article 7 (Authorised OECD Approach)	Allocation to DEMPE Article 9

wts global

Convergence Between Digital & Financial Services

USA

1. US banks have participated in 81 fintech start-ups deals 2012-17

>JP Morgan paid 400m for WePay

2. Banks increasingly (i) build Fintech in-house apart from investing and (ii) partner with external start-ups

>JP Morgan - $10.8bn on technology, $5bn on new tech investments. 2,500 people in its digital technology team and is advertising for 1000 positions with the word “digital”.

>Goldman Sachs - 9,000 engineers/tech staff

>PhD-level programmers - $150k

3. Bloomberg (16/01/2018): “Bank of America Tops IBM, Payments Firms With Most Blockchain Patents” cf financial instrument structures not patentable.

CHINA

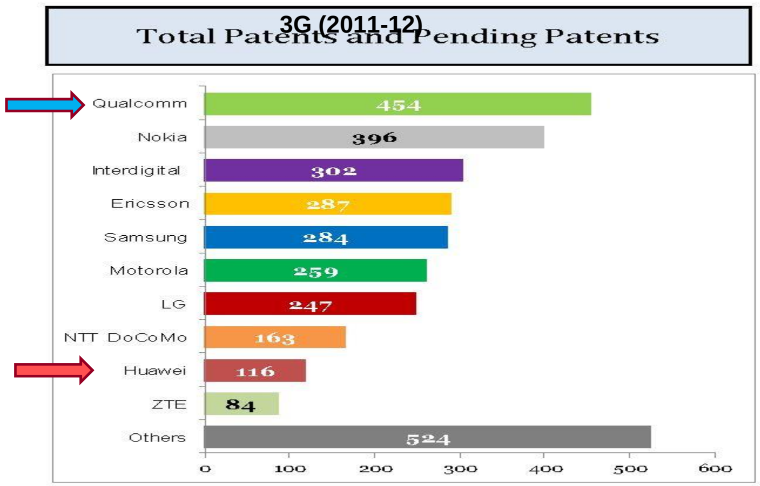
1. 27 fintech “Unicorns” in the world, 9 Chinese, 12 American.
2. Mobile payments (Alipay and Tencent) is just one of 7 key markets for China’s fintech industry. Other areas include online lending, consumer finance, online money-market funds, online insurance, personal financial management, and online brokerage.
3. PingAn Insurance

   > 20,000 technological R&D staff members, over 500 big data scientists, over 3,000 international and national patent applications. One Connect provides Fintech SaaS, AI, Blockchain, Cloud, Biometrics based solutions to 2,300 small and medium-sized financial institutions.

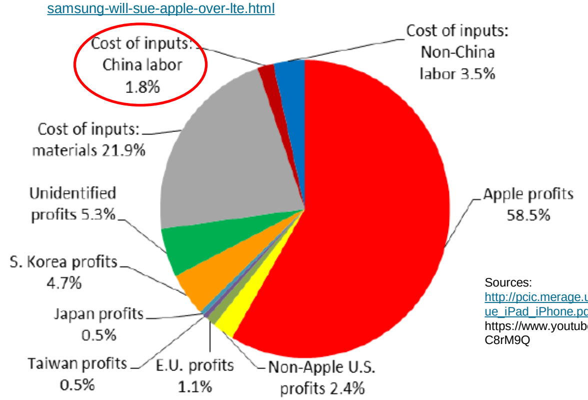
4. Virtual Banking licenses in China, HK, Singapore

   > Ant SME (Alibaba), Infinium (Tencent), Insight (Xiaomi)

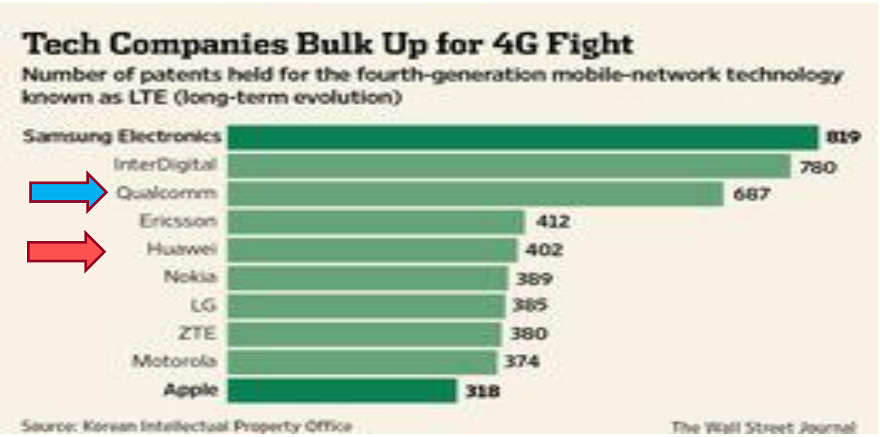
Khanna Parag: Asia is More than China - Path from Routine to Residual

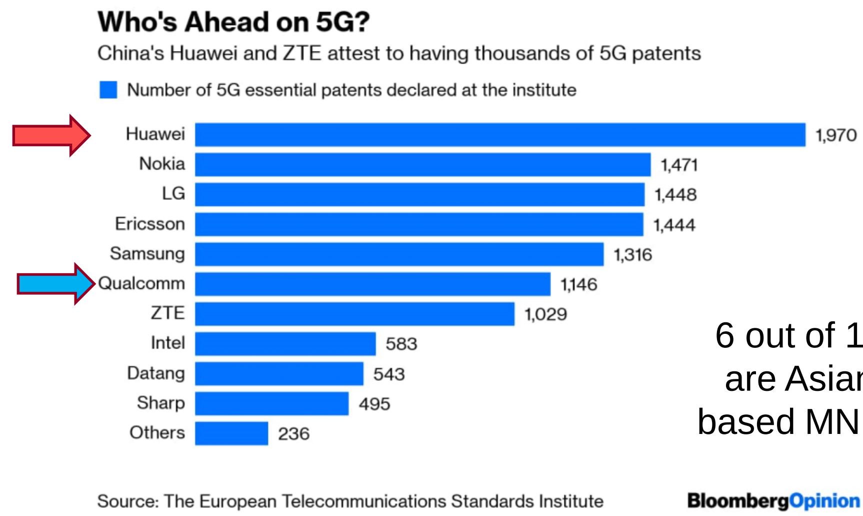


Source: https://www.patentlyapple.com/patently-apple/2012/09/korean-source-confirms-samsung-will-sue-apple-over-lte.html



Sources:
http://pcic.merage.uci.edu/papers/2011/Value_iPad_iPhone.pdf;
https://www.youtube.com/watch?v=8_eRMC8rM9Q





6 out of 10 are Asian based MNEs

wts global

The Asia Entreprenuer – A New Disruption?

How is it Different This Time?

1. First, standard setting; Second, creating, acquiring, owning and managing a portfolio of IP offshore in overseas investments goes beyond merely creating IP on a limited risk basis, it means first, performing more of the critical D E M P E functions and second, actually taking risks that is deserving of a share of profits, not just routine returns

   > Time to Re-examine Contract R&D at cost plus ?

2. What if Asia leads the application of global profit split and retains the residual?

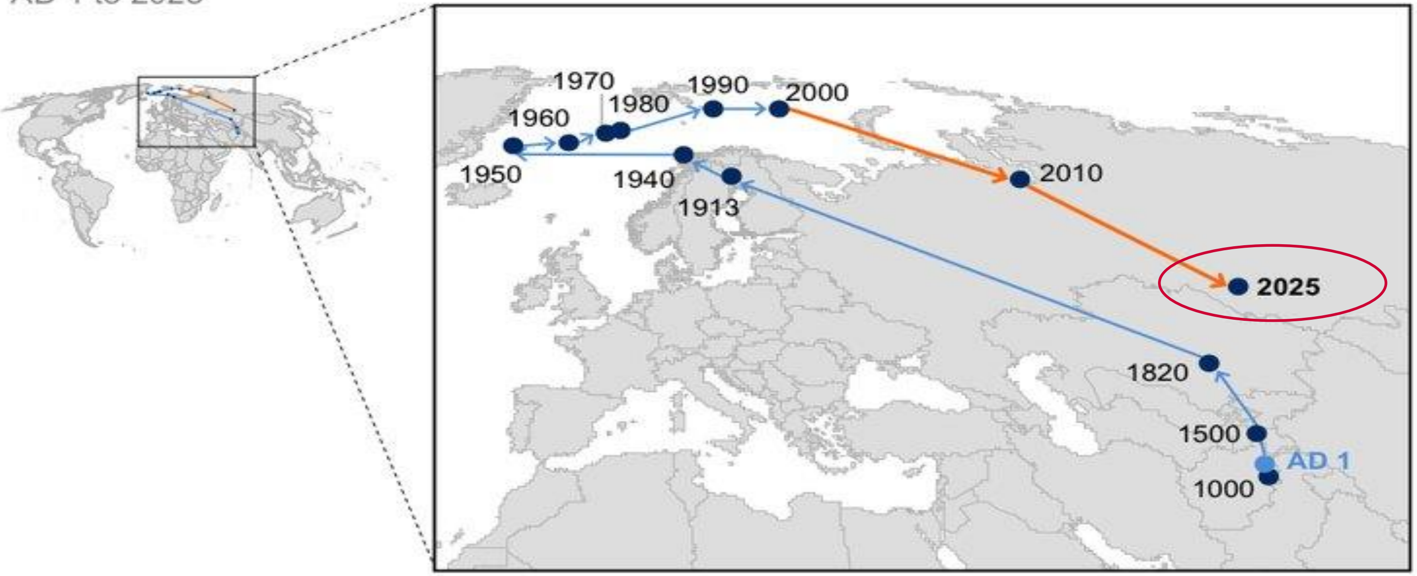
   > IP co. to hold the EMEA, Americas economic right/license to enable manufacturing or services in the US, Europe, SAAR and rest of world

   > Asian led Cost Sharing Arrangements, APAs?

The Future

By far the most rapid shift in the world's economic center of gravity happened in 2000–10, reversing previous decades of development

Evolution of the earth's economic center of gravity[1]
AD 1 to 2025



1 Economic center of gravity is calculated by weighting locations by GDP in three dimensions and projected to the nearest point on the earth's surface. The surface projection of the center of gravity shifts north over the course of the century, reflecting the fact that in three-dimensional space America and Asia are not only "next" to each other, but also "across" from each other.

SOURCE: McKinsey Global Institute analysis using data from Angus Maddison; University of Groningen