Fagligt Netværk

12 June 2023

ITR WORLD TAX TOP TIER FIRM 2023

AGENDA

- Current international tax landscape
- EU-developments
- Trends in Tax Authorities’ Approach to business restructurings, intangible assets and lost profit potential

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CURRENT INTERNATIONAL TAX LANDSCAPE

THE CURRENT INTERNATIONAL TAX LANDSCAPE

- The international tax agreement - The OECD Inclusive Framework Two Pillar Solution
- European Union initiatives
- New levies in the tax world
  - Digital Services Taxes (DST) and similar levies
  - Windfall profit taxes
  - Significant Economic Presence
- Trends in tax audits

EU DEVELOPMENTS

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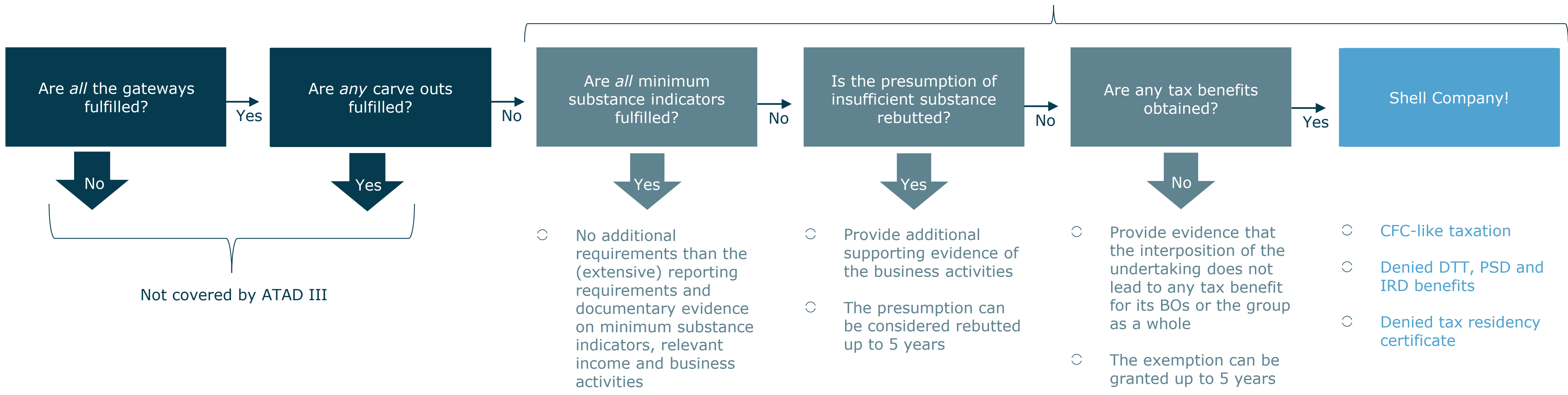
OVERVIEW OF EU INITIATIVES

- Un-shell directive (ATAD III)
- Pillar 2 directive
- Business in Europe: Framework for Income Taxation (BEFIT)
- Debt Equity Bias Reduction Allowance (DEBRA)
- Carbon Border Adjustment Mechanism (CBAM)

- Solidarity contribution
- Mandatory ETR publication
- CbCR
- Own resources – EU turnover tax
- NOL carry back recommendation

ATAD III - OVERVIEW

- Prevent tax avoidance and evasion that is likely to flourish through actions by undertakings without minimum substance
- Intended to be adopted by 30 June 2023 and come into effect from 1 January 2024 – not agreed on the European Council Ecofin meeting of 16 May 2023
- Reporting requirements on minimum substance indicators
- Non-compliance penalties (at least 5 % of the turnover in the relevant tax year)
  - MEP: Failure to report correctly min. 2% of an undertaking's revenue in the relevant tax year and 4% of revenue if false declarations.



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ATAD III – GATEWAYS (FOR HOLDING COMPANIES)

Are all the following gateways fulfilled (in the preceding two years)?

a) Passive element: More than 75% (MEP: 65%) of the revenue accruing is "relevant income";

b) Cross-border element: More than 60% (MEP: 55%) of the relevant income is earned or paid out via cross-border transactions; and

c) Third-party outsourcing element: Administration of day-to-day operations and decision-making on significant functions are outsourced (MEP: to a third part)

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ATAD III – CARVE OUTS

Are any the following carve-outs fulfilled?

a) Companies which have a transferable security admitted to trading or listed on a regulated market or multilateral trading facility;

b) Regulated financial undertakings;

c) Undertakings that have the main activity if holding shares in operational business in the same MS while their beneficial owners are also resident for tax purposes in the same MS;

d) Undertakings with holding activities that are resident for tax purposes in the same MS as the undertaking’s shareholder(s) or the ultimate parent entity; or

e) Undertakings with at least 5 own full-time equivalent employees or members of staff exclusively carrying out the activities generating the relevant income (MEP: Deleted)

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ATAD III – MINIMUM SUBSTANCE INDICATORS

Are all minimum substance indicators fulfilled (to be declared and documented)?

a) Own premises (or premises for its exclusive use);

- MEP: or premises shared with entities of the same group

b) One own and active bank account within the Union; and

c) One or more “exclusive” directors (i) or majority of equivalent full-time employees (ii)

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KEY ISSUES IN THE PILLAR II GloBE RULES

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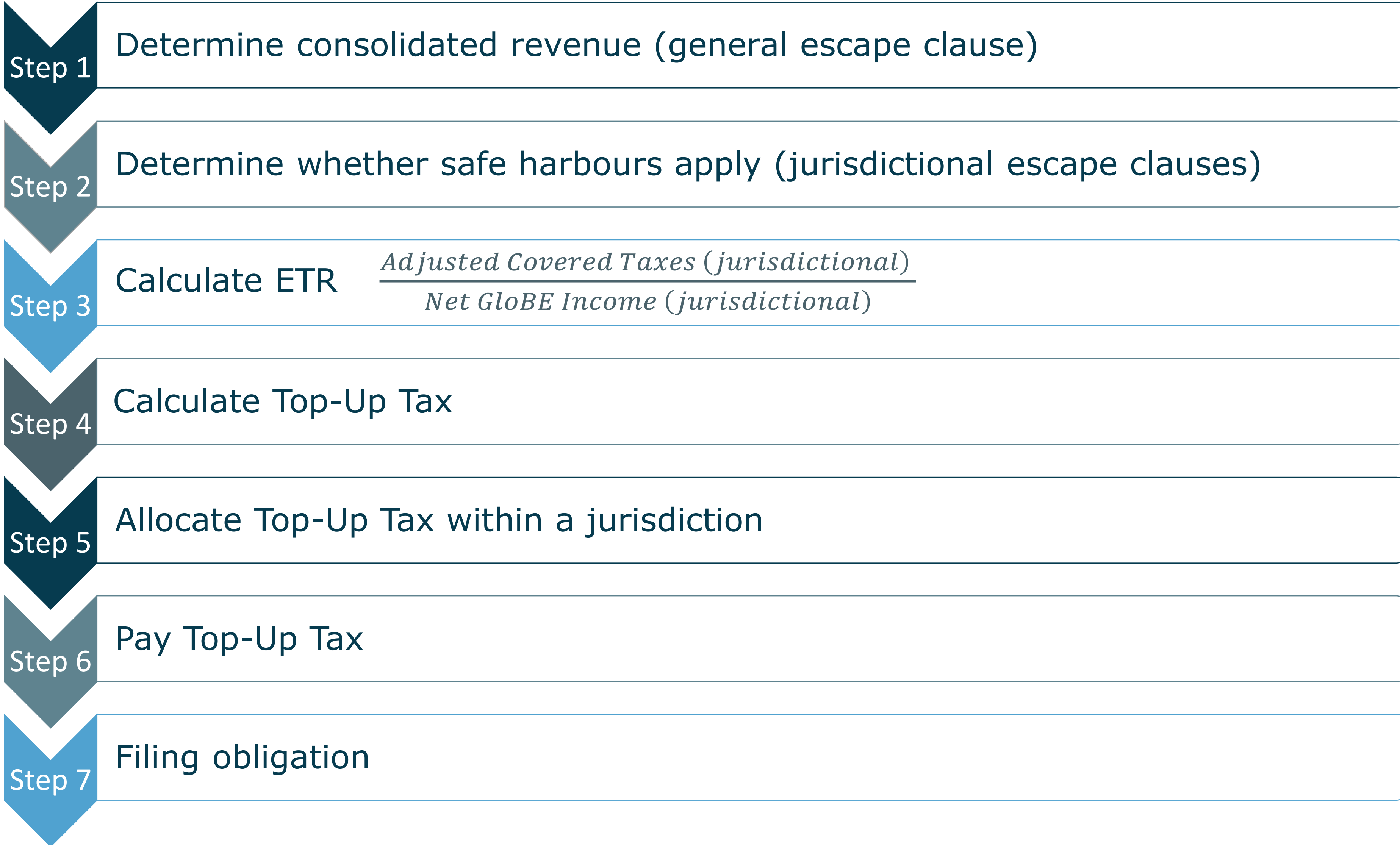
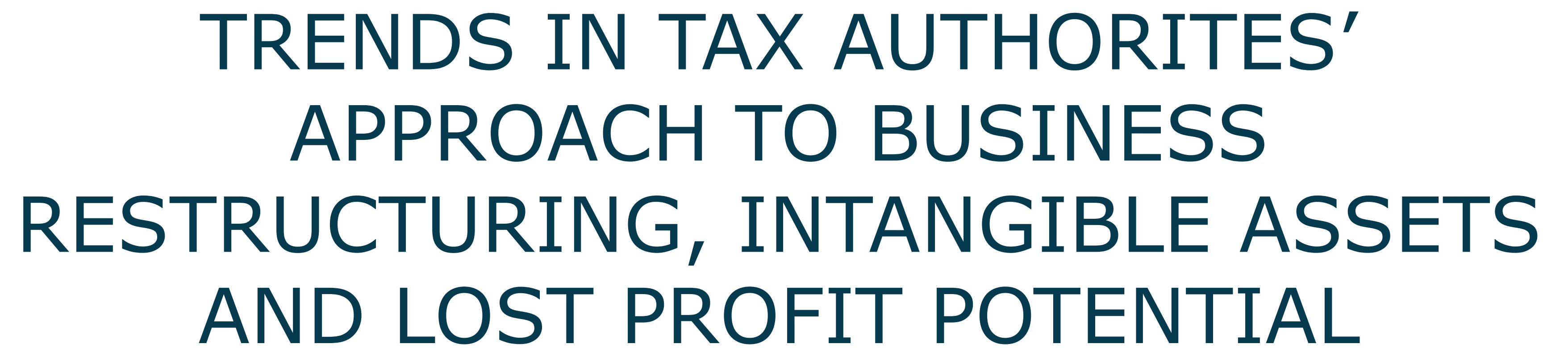
GloBE – BACKGROUND & FUNDAMENTAL QUESTIONS

- Agreement in EU on a Pillar 2 directive – implementation no later than 31.12 2023
- Other significant countries move on the agenda as well (UK, Japan etc.)
- But what about the US?
- Fundamental issues:
  - The tricky UTPR challenge
  - The close connection to financial accounting standards
  - The application of the EU GAAR to Pillar 2 accounting?

GloBE IN A NUTSHELL





TRENDS IN TAX AUTHORITES' APPROACH TO BUSINESS RESTRUCTURING, INTANGIBLE ASSETS AND LOST PROFIT POTENTIAL

BUSINESS RESTRUCTURINGS & INTANGIBLE ASSETS

Increased emphasis on business restructurings

- Transfer of functions and risks
- Relocation of employees – is it possible to transfer employees?
- Amended business procedures/reporting lines resulting in a shift of control of risks?
- Termination or amendments of contractual terms in IC agreements

Transfer of intangible assets

- The OECD TPG definition of intangible assets is broad
- Special considerations on HTVI
- Can transfer of DEMPE-functions result in transfer of intangible assets?

Applicability of the OECD TP Guidelines

- Generally, most developing countries follow the guidance and principles set out in the latest version of the OECD TP Guidelines
  - Either by reference to the guidelines in local TP legislation, amendment of domestic regulation to be in accordance with the updated guidelines or by treatment as “soft law”

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BUSINESS RESTRUCTURINGS & INTANGIBLE ASSETS

OECD TP Guidelines..

- .. on compensation for a decrease in expected future profits due to transfer of functions (9.39)
  - *"When applying the arm's length principle to **business restructurings**, the question is whether there is a **transfer of something of value** (an asset or an ongoing concern) or a termination or substantial renegotiation of existing arrangements and that* […] ***would be compensated between independent parties in comparable circumstances**."*

- ..on profit potential (9.40)
  - *"Profit potential is the **expected future profits (ex ante profit). In some cases it may encompass losses**. The notion of "profit potential" is often **used for valuation purposes**, in the determination of an **arm's length compensation*** [or] ***indemnification**..."*

- ..on termination or substantial renegotiation of existing arrangements (9.76 and 9.78)
  - *Terminations or renegotiations of arrangements **generally involve changes** in the risk and functional profiles of the parties, with **consequences for the allocation of profit potential between them**. In addition,* [the restricted entity might suffer] ***restructuring costs**, **reconversion costs and/or a loss of profit potential**. In these situations, the question arises of whether, at arm's length, indemnification should be paid to the restructured entity, and if so how to determine such an indemnification.*
  - *No presumption that all contract terminations or substantial renegotiations should give a right to indemnification at arm's length.* [This depends on] *the **accurate delineation of the arrangements before and after the restructuring*** […] ***and the options realistically available to the parties.***

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OVERVIEW OF RECENT CASE LAW (I)

Dutch case #1

- Change from fully fledged to contract manufacturer of chemical products
  - Dutch group company → production of chemicals → Fully fledged (CUP) → operating in a volatile market but has historically performed well in this market
  - 2008: Invests heavily (EUR 4M) in production facility and increases capacity with 39%
  - From 2012: enter into supply agreement with J Ltd. transferring the market risks, as J Ltd. is obliged to purchase the entire surplus capacity (39%) at cost + 5%
- The court rejected the conversion to a contract manufacturer – not being in the taxpayers' interest to enter into the supply agreement
  - Unlikely that an unrelated party would be willing to surrender the substantial (expected) margins for a 'risk free' return of 5%
  - Taking historical performance and the investment made into account, the supply agreement was not the best among realistic alternatives
  - No actual change in functions (production and logistics) or asset base
  - BM was rejected – not comparable companies and [E BV] should not act as tested party (too complex)

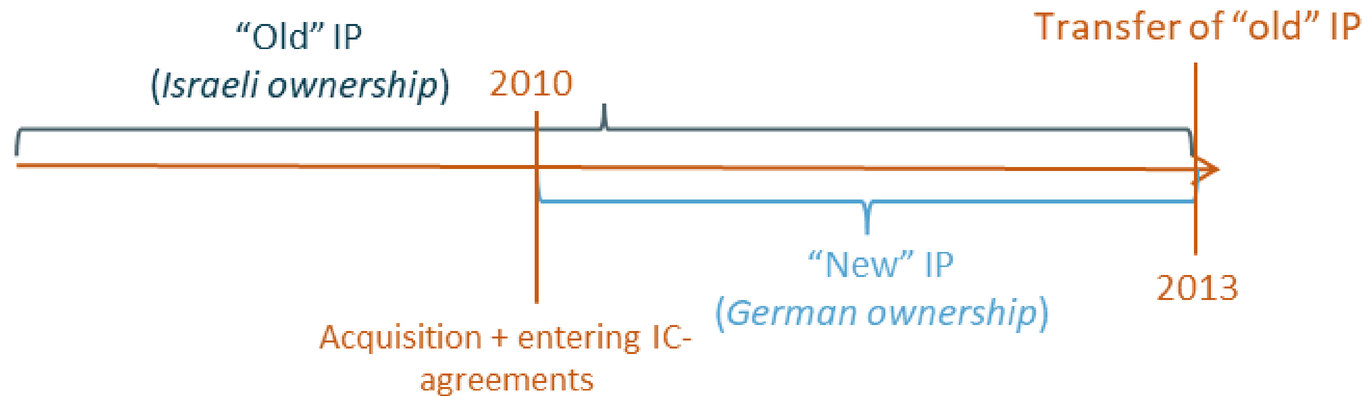
Dutch case #2

- Conversion of Dutch processor of cocoa and soybeans – from fully fledged manufacturer to toll manufacturer (routine remuneration)
- Relocation of employees to centralized CH function. Is this transfer of assets or going concern?
- Transfer of market expertise (profit potential) - determined by independent expert and supported by the court
  - 33 employees have been relocated
  - Significant decline in NL revenue and CF post restructuring
  - Corresponding increase in CH revenue and CF post restructuring

OVERVIEW OF RECENT CASE LAW (II)

Israeli case (pre-BEPS 2017 update of TPG)

- Post acquisition of Israeli company (by German parent) an IC-agreement was entered leaving target as limited risk service provider → target became profitable
- Court concluded in favor of the taxpayer since the tax authorities had not documented that the IC-agreement was not among the best realistic alternatives
- The court found:
  - No transfer of functions
  - No transfer of "old" IP
  - No transfer of risks



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OVERVIEW OF RECENT CASE LAW (III)

Danish case #1

- Termination of royalty agreement to motor program from DK branch to German HQ - economic ownership of IP
- Tax tribunal: Branch had economic ownership of IP, which was transferred as part of termination of service agreement
  - Compensation should exceed the lost profit potential merely in the termination period

Danish case #2

- Conversion of software sales company to commissionaire, i.e., own booked income → acting on behalf of the group
- Tax tribunal: conversion triggered transfer of valuable IP (marketing intangibles)
  - Compensation set at lost profit potential for 10 years (expected lifetime of clients)

Danish case #3

- Valuation of transfer of IP
- Tax tribunal: Supported the DCF-method applied by the independent expert, but had several adjustments
  - Seller's own budgets of projected revenue from the transferred IP to be used (no downward adjustments)
  - The entire TAB (Tax Amortization Benefit) of buyer should be included in the valuation (*not* half but *all* of buyer's tax benefit)

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DRAFT GUIDANCE ON VALUATION OF IP

Draft guidance on valuation principles, including TP valuation

- Relevant methods:
  - Third party share purchase is relevant when IP is transferred to an associated party shortly after the share deal (CUP)
  - DCF, taking both parties perspective into consideration when assessing the factors to be included in the (one) valuation – in practice, the most applied method
  - Relief for royalty, only reflects the value of the existing IP and not the value embedded in the ownership and control of the IP such as the right to continue development – normally not applicable for unique IP
  - Cost based valuation - should be avoided

- Specific issues:
  - Options realistically available
    - Unless a price in the range between seller's min. price and buyer's max. price can be determined, e.g., based on an analysis of bargaining power, the price should be set as the midpoint of the range
    - If seller's min. price is higher than buyer's max. price, the price should take outset in seller's min. price
  - Tax effects should be included in the valuation
    - Tax on expected future cash flows (buyer and seller)
    - Buyer's expected tax amortization benefit (TAB)
    - Expected taxation of seller's gain upon sale
  - Routine functions
    - The value of the remining business can be estimated as the market value of fixed assets, e.g., based on book value or PPA
    - Any added value could be based on competitive advantage (that a third party would be willing to pay for) – depends on terms of the agreement, the possibility of outsourcing to low-cost countries, entry barriers, etc.
    - Any significant added value is considered related to remaining IP
  - HTVI

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COUNTRY FLAVOUR (I)

Summary based on high-level input from local tax advisors in our neighbor countries

Topic	High-level flavor
General landscape	○ Clear that it is a complex area surrounded by significant legal uncertainty *but* something which is prioritized and high on the agenda of tax authorities ○ With respect to case law most local advisors indicate that there are examples of either administrative rulings or court rulings on transfer of functions following a re-organization
Transfer of functions *Does a re-structuring involving a relocation of decision-making functions trigger a taxable event*	○ Transfer of a function in terms of an important decision-making function (and associated assets and risks) would likely trigger a taxable event ○ Compensation should be based on what an unrelated party would require for the transfer of such functions (and associated assets and risks)
Valuation *Valuation of the transfer of functions, including whether future routine profit can be deducted in the valuation of the compensating payment and whether the value of any transferred function could be "capped" to what is considered "old business"*	○ The compensating payment will most likely include an assessment of the expected future profit, i.e., lost profit potential should be added ○ The value of "lost profit potential" would likely be reduced with the future remaining (routine) profits or at least that there are good arguments supporting that this approach applies ○ GE: Future routine profits should most likely only be considered if such future routine profit results from functions of the old business model *remaining* in the local entity ○ The exit tax exposure could likely be capped to taxation of the value of "old business"

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COUNTRY FLAVOUR (II)

Summary based on high-level input from local tax advisors in our neighbor countries

Topic	High-level flavor
Run-off payment *Can a trigger point/event with a subsequent run-off payment (related to the "old business") and a concurrent implementation of a new setup support that nothing of value has been transferred*	◌ No clear answer, as this is highly fact depend. However, if properly documented and if sound and supporting arguments and valuation documentation can be conducted, it could be argued that nothing has been transferred ◌ GE: The authorities are quite aggressive and there is a high risk that a transfer of functions must ultimately be assumed, even though it is argued that the re-organization consisted of a close down of "old business" and a subsequent implementation of "new business". ◌ Seemingly, no rulings concerning the tax authorities' approach towards this solution have been published
Need of a "trigger point" *Should a specific trigger point be identified or could a more "ongoing" trigger point could be accepted from a local tax perspective*	◌ Overall, a "trigger point" or a "tipping point" is needed from a local tax perspective.

TRENDS & CONSIDERATIONS

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- The TP documentation and submitted information (still) play a significant role
  - We see cases where taxpayers try to argue against the FAR analysis in the TP documentation without success – in contrast it seems to decrease their credibility

- OECD on termination or substantial renegotiation of existing arrangements
  - What if risks and assets were wrongly allocated in the first place, are any assets etc. then transferred and is any profit then "lost"?
  - Changes to the TP-setup in general, is anything of value transferred?
    - Changes to the TP-remuneration (within the arm's length range)/TP-method without any changes to the functions performed, risks assumed etc., can compensation be triggered?

- Increased focus on lost profit potential also among advisors/auditors

- Termination or amendments of contractual terms in IC agreements
  - When will third-parties accept termination without compensation?
  - Can a termination period of IC-agreements compensate for the remuneration of lost profit potential? How is this sufficiently substantiated/documented?

- To what extent can the guidelines related to HTVI mitigate the risk exposure related to valuation of "lost profit potential"?

THANK YOU