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Financial Services Transfer Pricing

Sector trends & global developments

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Welcome

A warm welcome to Deloitte's Financial Services Transfer Pricing global publication. Our collection of articles is inspired by a range of topics including US Tax reform, Brexit, technology disruption in financial services, as well as the Work Programme set out by the Organisation for Economic Cooperation and Development ("OECD") to deal with the tax challenges arising from digitalisation of the economy. As usual, with insights from our Financial Services ("FS") Transfer Pricing teams from around the Deloitte global network of member firms, the objective is to discuss transfer pricing trends within FS across banking, insurance and asset management.

In this edition, the article series starts by revisiting the extent of global adoption of the Authorised OECD Approach ("AOA") to Permanent Establishment ("PE") profit attribution and application within the banking sector. We move on to discuss some of the key areas of tax audit activity within transfer pricing and progress in resolving double taxation. The spotlight then shifts to US Tax reform, and in particular any knock-on transfer pricing considerations. We revisit transfer pricing considerations arising from Brexit contingency planning, and also transfer pricing developments in the alternative asset management sector. Technology is at the heart of the next two articles, and the impact on the Banking and Insurance sectors and comparable transfer pricing methodologies adopted. Next is a discussion on the importance of VAT when implementing transfer pricing policies. We finish off with a summary of the two Pillars contained within the recent OECD proposals on a work programme to tackle the tax challenges arising from the digitalisation of the economy.

This publication is intended to be informative. Feel free to reach out to the listed Deloitte Financial Services Transfer Pricing team contacts for more information or in case of any questions.

MAP
TECHNOLOGY
DIGITALISATION OF THE ECONOMY
US TAX REFORM
BROKERS
KERT
GLOBAL
OECD
ASSET MANAGEMENT
BANKING
BREXIT
APA
DELOITTE
FINANCIAL SERVICES INDUSTRY
VAT
BUSINESS
TRANSFER PRICING
RESTRUCTURING
INSURANCE
GLOBAL TAX DISPUTE RESOLUTION

Application of the AOA in the Banking Sector

Nine years ago, the organization for economic co-operation and development (OECD) published the 2010 Report on the attribution of profits to permanent establishments (the PE Report). The purpose of the PE Report was to address the considerable variation in the interpretation of the general principles, which govern the attribution of profits to a PE under Article 7 of the OECD Model Tax Convention and ensure a more consistent application of the rules of the Article and avoid double taxation of profits attributable to PEs.

Thus, the OECD established the concept of the “authorized OECD approach” (AOA), which presents the basic idea to treat a PE as if it were an independent and functionally separate entity engaged in the same or similar activities under the same or similar conditions. Under the AOA, profits are attributable to a PE based on a comparability analysis, taking into account the functions performed, assets used, and risks assumed by the PE.

As banks and other enterprises in the financial services industry operate under a PE structure in many cases, the OECD sought input from the industry to provide detailed and practical guidance on the application of the AOA to PEs of

- banking enterprises (Part II of the PE Report) and
- enterprises carrying on global trading of financial instruments (Part III).

Insurance enterprises were covered separately in Part IV of the PE Report (not covered in this article). The fundamental principle underlying the attribution of profits to PEs in both Parts II and III of the PE Report is the concept of the key entrepreneurial risk taking (KERT) function. Under this concept, financial assets, such as loans or trading assets, are attributed to the PE where the KERT function is performed. The capital required to fund the assets as well profits or losses associated with the assets taking into account any dealings with other parts of the same enterprise are attributed to the KERT location on the same basis.

While the trading function, including pricing and the decision to enter into or hedge the trades in a book is typically the KERT function in trading businesses, negotiating the contractual terms of a loan and deciding, if and on what terms to advance a loan to a client is generally treated as a KERT function in the commercial lending business. Depending on the product, type of business and strategy, certain other functions, e.g., the marketing function in the retail lending business or the risk management function in the ongoing management of an existing loan portfolio may be the KERT function under the AOA. For the attribution of capital, Part II of the PE Report envisages the BIS ratio approach, the thin capitalization approach or, as a safe harbor, the quasi thin capitalization approach (https://www2.deloitte.com/global/en/pages/tax/articles/transfer-pricing-global-publication.html).

Almost a decade after the PE Report was finalized, questions still remain; how widely accepted is the AOA around the globe? Are tax authorities consistent in their application of the AOA, where it has been incorporated, into local law and tax treaties with other countries to avoid and mitigate double taxation? To assess the acceptance of the AOA and understand the differences by jurisdiction, Deloitte conducted a survey of its global network of firms to identify adoption and application of the AOA.

Based on the results of the survey summarized in the table below, the AOA is either incorporated into domestic law or at least accepted in tax treaties of the majority of countries. However, differences remain in the interpretation of the AOA, which can result in double taxation and additional documentation efforts for global banking enterprises operating through a branch network:

Country	What is the basis under domestic law for the attribution of income to PEs?	If AOA or domestic TP rules are the basis for attribution of income to PEs, is there detailed guidance particularly with respect to the attribution of free capital?	Under your country's tax treaties and domestic law are taxpayers given the option of applying AOA for the determination of income to PEs?	Are there local requirements for annually documenting the attribution of income to PEs? If so are the documentation requirements the same or similar to TP documentation requirements?	Is there tax controversy over the attribution of income to PEs in your country and are you aware of cases where taxpayers have requested Competent Authority to resolve this type double taxation?
Australia	Separate entity hypothesis but different from AOA	Not based on AOA or TP rules Australian domestic law and rules under PCG 2018/1	No	Yes	Yes, The ATO's Foreign Bank Strategy group for inbound banks focuses on (amongst other things) branch attribution tax outcomes
China	Local TP rules	Working capital without compensation of no less than CNY200 mn or the equivalent required	No	Yes	Yes, but less frequent than TP examinations
France	No specific rules, however, AOA is generally accepted	No	Yes	No local requirements	Yes, APAs and MAP cases
Germany	Domestic TP rules incorporates AOA	Yes	No	Yes, in addition to the general TP documentation, a tax balance sheet is required	Yes, APAs and MAP cases
Hong Kong	Domestic TP rules based on AOA, along with sourcing rules. How the two apply together is not yet clear	Detailed guidance is pending	Publicly stated as so but yet to be documented in IRD guidance	Yes	There are disputes which typically get settled domestically
India	Arm's length principle within local TP rules	There is no AOA guidance however banks are subject to regulatory capital levels set out by the Reserve Bank of India	No	Yes	There is significant controversy
Indonesia	Force of attraction rule	No	No	No local requirements	There are disputes which typically get settled domestically
Ireland	Domestic TP rules, but AOA expected to be accepted	No	AOA may be applied depending on the treaty	Yes	Yes, MAP cases
Italy	Domestic TP rules that follow the AOA	Yes, specific guidance for PEs of non-resident banks as per the Director Decree dated April 5th 2016	Generally, tax treaties follow the AOA	Not mandatory, but taxpayer can prepare TP documentation for penalty protection purposes	Yes, by means of requesting to start MAP
Japan	Domestic TP rules incorporate AOA	Yes	Under all treaties with specific language; others require specific analysis	Yes	Yes, but few observations as domestic rules are still relatively new
Korea	Domestic TP rules, similar to AOA approach	Yes	Local TP rules similar to AOA	Yes	Yes, but APA or MAP are not a common resort used by PEs, as they are a lengthy and complicated process
Luxembourg	Domestic TP rules apply. Most treaties apply the AOA	Not applicable	Depending on the treaty	Yes	No, not aware of any specific cases
Malaysia	Based on domestic TP rules and source rules	No	Nothing specific but in practice AOA principles may be used	Audited accounts and annual TP documentation	Minimal
New Zealand	Separate entity hypothesis but different from AOA	No	Does not endorse AOA as outlined in the latest model tax convention; follows approach under pre-2010 model tax convention Must file branch financial statements if the branch size is above a certain threshold	No TP like requirements Must file branch financial statements if the branch size is above a certain threshold	Attribution of profits to a PE is always a matter of debate
Singapore	Based on domestic TP rules	No	No	Yes	Regularly inquired about by IRAS
Spain	Domestic sourcing rules. Where there is a treaty, general TP rules apply	Not applicable	No	Yes	Yes, bilateral APA cases
Sweden	Limited guidance available, but case law provides for the AOA to be applied	No	Yes, based on case law it is expected that the AOA is applied	Yes	Yes, specifically loss making PEs
Taiwan	Force of attraction rule	Not applicable	No	No TP like requirement Books and records requirement	There are disputes which typically get settled domestically
Thailand	Source based rule	Not applicable	No	TP documentation	A few non-FS APA cases
USA	Depending in the treaty and type of income AOA or ECI rules may be applicable.	No	Yes, depending on the treaty and type of income, but must be applied consistently.	Yes, depending on the treaty and type of income, but generally recommended for all.	No, not aware of any specific cases.
UK	Domestic rules for taxing permanent establishments, including Banking specific provisions. Follows separate enterprise principle. Depending on the treaty AOA is broadly applied.	Yes	Yes, depending on the treaty AOA is broadly applied.	Yes, based on a judgement approach.	Yes, APAs and MAPs.

Based on a survey of Deloitte Global network of member firms as at June 2019

The positive conclusion is that the AOA continues to be incorporated into local legislation and treaties, most recently in Hong Kong, where the AOA has been introduced with effect from April 2019. However, there are a number of key countries for the financial services sector, where the AOA has not been implemented into domestic law, including Australia and the US.

While the AOA embodies the "functionally separate entity" approach and does not limit the profit attributable to a PE by reference to the profit of the enterprise as a whole or a particular business activity in which the PE has participated, Australia follows the "relevant business activity" approach. In practice, this means the profit attributable to an Australian PE is limited to the actual profit of the enterprise, and dealings between PEs and head office can only be recognized for the purposes of determining the attribution of actual revenue and expenses.

In the US, the basis for the attribution of assets, capital and income to a PE very much depends on the type of tax treaty (i.e., AOA or non-AOA treaty) and the type of income under US domestic law (US Code-based rules). To date the US has accepted the AOA in seven tax treaties, with the UK, Japan, Germany, Belgium, Canada, Iceland and Bulgaria while another three AOA treaties are pending. In cases where an AOA treaty applies, the AOA may be used on a year by year basis interchangeably with the US Code-based rules as long as the choice is applied consistently to all of the PE's businesses in a given year. However, as the US Code-based rules are quite complex and much wider than the AOA principles, assets and associated income that are attributed to a KERT function outside of the US under the AOA, may still be regarded as effectively connected income (ECI) under the US Code-based rules.

Even in the countries that have incorporated the AOA into domestic law as a basis for a common framework since the 2010 PE Report and simultaneous update of the Model Tax Convention were issued, differences in interpretations remain which can result in double taxation in certain circumstances. One continued source of differences in the attribution of profits to a global network of banking PEs stems from 2010 OECD PE Package itself. While Part II of the PE Report sets out two authorized approaches and one safe harbor approach for the attribution of capital to a PE, the commentary to the Model Tax Convention defers to the capital attribution rules of the PE host country. As the results of the survey show, there are specific requirements for the attribution of free capital to the PE in a number of countries. Examples include Germany and Japan, where inbound PEs are generally required to be attributed free capital in line with the BIS ratio approach. In the UK, on the other hand, capital attributable to the PE of a foreign bank is determined under the thin capitalization approach for tax purposes. Under this approach, a UK PE is expected to have a level of equity comparable to that of similar independent banking enterprises in the UK engaged in similar business activities under the same or similar circumstances. However, in cases where it can be demonstrated that no UK bank is engaged in sufficiently comparable business activity on a similar scale to the UK PE in question, HMRC may accept the BIS ratio approach as a proxy.

Likewise, as the table above shows, taxpayers have to be mindful of country specific documentation requirements that may apply to local PEs even in countries where the AOA has been incorporated in local law. In Germany, for example, a tax balance sheet (also referred to as "Auxiliary Calculation") has to be prepared by the time the corporate tax return for the PE is submitted. In many cases the tax balance sheet for a banking PE will equate to its balance sheet for financial accounting purposes, if the booking policy for accounting purposes is in line with the AOA in general and the KERT principle in particular. If, however, the financial accounting is not in line with the AOA, e.g., where a loan was booked in the financial accounts of the foreign head office, whereas the KERT function in relation to that loan was performed in the German PE, the tax balance sheet of the German PE would generally have to be adjusted to reflect that. Where appropriate, taxpayers may alternatively demonstrate in the supporting documentation that through arm's length dealings and adjustments to the free capital required to support the loan, the financial results of the PE correspond to the financial results that would accrue, if the asset had actually been booked in the German PE where the KERT function was performed.

In the UK, we have witnessed similar issues with regard to potential differences in the attribution of assets to a UK Banking PE for tax return purposes versus the branch balance sheet. This also impacts the bank levy calculation so requires careful consideration to avoid over-inflating or underestimating the branch balance sheet for corporate tax and levy purposes. The role of the UK PE, and whether it undertakes the KERT function, is important in this respect. There is a specific domestic provision within the UK PE rules that acknowledges the differentiation between acting as principal versus intermediary and the transfer pricing impact in the latter case.

While a lot of progress has been made since the OECD PE Report defined the AOA in 2010, the survey and examples show that differences in the approaches to the attribution of profits to PEs and interpretation of the AOA remain even among countries that have incorporated it into domestic law and tax treaties. As a result, there are incidences of controversy and MAP cases in relation to attribution of profits to PEs in almost all countries surveyed. One way to address these differences and the potential risk of double taxation upfront is an Advance Pricing Agreement ("APA"). APAs involving PEs have been negotiated with almost half of the countries reflected in the survey already and are becoming an increasingly powerful tool in giving taxpayers certainty on their transfer pricing position.

Tax controversy and dispute resolution in financial services

Tax Controversy and dispute resolution in Financial Services

Since the OECD launched their 15 point Action Plan to mitigate Base Erosion and Profit Shifting ("BEPS") back in 2015, the global tax landscape has changed considerably. Tax law changes across the globe, including Diverted Profits tax rules in the UK ("DPT", albeit earlier in April 2015) and Australia (multinational anti-avoidance law ("MAAL")), the European Union Anti-Tax Avoidance Directive ("ATAD"), the Base Erosion and Anti-Abuse Tax ("BEAT") in the US, and adoption of the Multi-lateral Instrument (in part or otherwise) have seen countries implement these measures and more.

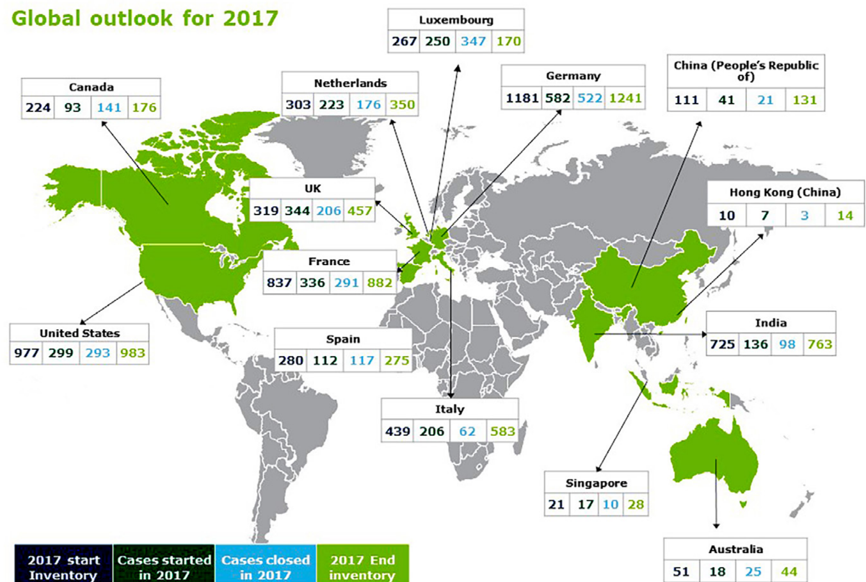
The effect of Actions 8-10 (Aligning Transfer Pricing Outcomes with Value Creation) has arguably taken slightly longer to translate into tax authority action on a global scale. Recent activity suggests this is changing rapidly. The other articles within this publication pick up some of these challenges; in this article we focus on some of the key areas where we have witnessed increasing scrutiny across the financial services industry, as well as discuss potential mechanisms to pre-empt, defend or otherwise manage such matters.

Control over risk

The 2017 OECD Transfer Pricing Guidelines acknowledge the significance of regulation in the Financial Services sector as well as referencing the guidance in Parts II-IV of the 2010 OECD Report on the attribution of profits to permanent establishments ("PEs")[1]. Regulators will require a certain level of local and suitably qualified personnel to manage risk. This is often the first line of defence against any tax authority challenges that control or decision making lies elsewhere. We are however seeing instances of tax audit activity in this respect, around remote booking situations (be it credit decisions on loans in a banking context, or underwriting in insurance). In particular, recent examples of scrutiny by the UK Tax authority ("HMRC") have focussed on booking in Crown Dependency locations and the split of functions between there and the UK. This is particularly interesting given the recent legislation in these territories incorporating substance requirements across certain activities including financial services. A "drains up" review of functional capability, decision making and operational controls is recommended as an asymmetry of profits and value creation may prompt tax authority enquiries, not only on transfer pricing but also PE and diverted profits tax questions from a UK perspective. Residence and the place of effective management (as a treaty tie-breaker) should also not be taken lightly.

Head office costs

Gold standard regulation and significant IT investment programmes continue to make this a dilemma from a transfer pricing perspective. Leaving aside transfer pricing, we are seeing increasing numbers of overseas regulators refusing to allow such charges to be levied from the Centre, in particular in the Banking sector. Retention of the costs at the Headquarter ("HQ") location has subsequently lead to tax authority audits there. Debates can be had around the quantum which can be attributed to the shareholder function, but this is likely to still leave a residual amount that may be challenged as the HQ tax authority argues the costs should be pushed out. Leaving aside cost of living adjustment arguments, MNE's then face the prospect of proving the benefit test is met locally (assuming regulatory hurdles are overcome). Requests for Mutual Agreement Procedures ("MAPs") have been made to try and resolve these issues; the path towards such a potential resolution is also littered with potentials pitfalls for



Source - https://www.oecd.org/tax/dispute/mutual-agreement-procedure-statistics-2017-per-jurisdiction-all.htm

1 OECD Transfer Pricing Guidelines 2017 Chapter I Section D.1.2.1

the unwary (for example, the interaction locally with the domestic litigation path, self-assessment in one country preventing acceptance into MAP in the counterparty territory). Local advice is therefore key to avoid missteps which may prevent entry into MAP.

Funding

The OECD BEPS Public Discussion Draft on Financial Transactions released on 3 July to 7 September 2018 coverage of transfer pricing has certainly increased debate in this area, although given it remains non-consensus a near term resolution appears out of reach. We understand tax authorities in Canada, Germany and the US are potentially in favour of the Group credit rating rebuttable presumption approach, whereas for example we understand the UK remains behind the stand-alone rating approach (in line with the current UK statutory approach). Tax authority challenges are increasingly focussing questions around why the interest rate on inter-company funding differs from the group funding rate. Indeed, based on published guidance, the Australian Tax Office ("ATO") acknowledges lower tax risk where the group rating is followed. Following the notching approach laid out in the Standard & Poor's rating agency guidance[2] may be a starting point as a compromise way forward in the interim (as also referenced in the Discussion Draft), and for financial services following the Moody's methodology which advocates notching the issuer rating to reflect the subordination effect of an issuance at the holding company as opposed to the operating company level[3] merits consideration. As well as the issuer rating, careful consideration should be given to the terms of the debt which may impact the rating for a specific issuance.

The introduction or tightening of corporate interest restriction rules globally has potentially reduced the focus on transfer pricing of debt more broadly, in particular where there is a full or substantial restriction for shareholder debt. Leaving aside carry forward rules, the transfer pricing then becomes partly academic. However, this is not so across financial services where typically, say, Banking or Insurance groups will generate net interest income. Transfer pricing therefore remains of paramount importance in these sectors. As well as the funding itself, close attention to any guarantee arrangements and their pricing is also recommended.

Dependent Agent PE ("DAPE")

The revised Article 5 of the OECD Model Treaty reduces the threshold for crystalizing a DAPE. This has resulted in an increased focus on mobility policies within financial services groups, notwithstanding that a number of countries have not signed up to this aspect of the Multilateral Instrument ("MLI"). Such focus is not unwarranted given the approach of tax authorities (notably in continental Europe) to the question of whether a DAPE (or indeed a fixed place of business PE) has been created by the "travelling sales people". Whether the reduced threshold has been enshrined in domestic legislation or the tax authority has sought to re-look at cases under the old or existing definition (with a BEPS lens on), audit activity has increased. This is despite the fact that the tax treaty may retain the existing definition, and MAP could therefore be available to the taxpayer. Regardless, the process takes up management time and cost, dealing with information requests, functional analysis interviews, and intrusive enquiries around travel itineraries. Proactive decisions to file a technical PE return, even if only a nil return (on the basis the transfer pricing is correct) may also have knock-on consequences of prior year audits. Careful consideration of all these factors as well as reviewing service agreements ("SLAs") and operating guidelines for key mobile staff should be high on the agenda.

Application of the Cost plus method ("CPM")

Instances of tax authorities pressing for a fee or profit split approach, to reward what they perceive as value adding functions, instead of the CPM policy adopted are becoming more common. Examples include the Indian tax authorities in certain private equity sub-advisory situations. This is potentially a dangerous path for taxpayers, even if the calculations are undertaken by the taxpayer merely as support on a corroborative basis only. This may set a precedent for authorities to push for adoption of the policy in practice which can lead to more complexity and operational transfer pricing considerations. Negotiation of an increased "plus" can often be the end result from such enquiries, in particular where the home jurisdiction tax authority is willing to engage in MAP in support of the taxpayer position. Disputing CPM can of course be a "double edged sword", as in many cases across banking and investment management adoption of a cost-plus floor policy as a downside protection for a fee/revenue split model based on activity or Assets Under Management ("AUM") respectively provides tax authorities with effectively a one-way bet. If the cost plus floor were completely removed, it would in our experience in many cases lead to losses locally (which may also have knock-on regulatory consequences) where insufficient activity is generated.

2 www.standardpoors.com
3 www.moodys.com

Summary

There has been a noticeable escalation in tax authority enquiries over the last year, a slight time lag from the initial expectation of transfer pricing audit activity post BEPS. As well as a general increase across MNE's, we have also witnessed increased audit activity across the financial services sector. More detailed information requests are commonplace which places an additional compliance burden on tax departments (on top of Action 13 Master file, Local File and Country by Country ("CbyC") reporting obligations globally). We have yet to see significant audit activity being triggered by CbyC filings, but we cannot rule this out in the future. We expect more MAP cases, and pre-emptively more APAs to be considered.

There seems a willingness from taxpayers and tax authorities to contemplate APAs in more cases, for example, for post-Brexit operating models which should help mitigate future disputes on these matters. Conversely, in the absence of MAP we may see more domestic tax litigation cases in transfer pricing. We have seen a number to date dealing with cash pooling and financing but otherwise relatively few.

Deloitte Global network member firm panel at our June 2019 Banking & Asset Management Transfer Pricing seminar in London

US tax reform and its consequences for the banking sector

On December 22, 2017, President Trump signed legislation commonly referred to as the "Tax Cuts and Jobs Act," which comprehensively revised certain provisions of existing tax law. Under tax reform, corporate tax rates are permanently reduced, and a major goal of tax reform is to incentivize multinational companies to increase the amount of profits reported in the United States.

In addition to reducing the corporate

tax rate from 35 percent to 21 percent, tax reform modifies the definition of intellectual property to include items such as goodwill, going concern value, and workforce in place. Tax reform also introduced three separate incentive mechanisms: global intangible low-taxed income (GILTI), foreign-derived intangible income (FDII), and the base erosion and anti-abuse tax (BEAT).

BEAT poses a particular challenge for the banking sector

The BEAT is one feature of tax reform that is likely to have a substantial impact on the banking sector. The BEAT potentially applies to companies that do business in the United States and that generate average revenues greater than USD 500 million during the most recent three years. The BEAT contains another threshold metric, the so-called base-eroding percentage (BEP), computed as the ratio of base-eroding deductions (e.g., including payments to related parties outside the United States) to the company's total deductions, which in the case of financial institutions is 2 percent, and 3 percent for all others. If the BEP exceeds this threshold, then a tax surcharge equal to the difference between the normal tax liability and a separate tax liability calculated without regard to the deduction of base eroding payments would apply.

Taxpayers who wish to limit the application

of the BEAT should consider the terms of transactions with foreign affiliates and should carefully monitor the base erosion

percentage with regard to the 2 percent safe harbor limit. As part of this process, it may be possible to identify specific transactions that can be excluded and thereby permit the taxpayer to stay under the BEAT threshold. Certain payments are excluded from BEP computation, including items such as cost of goods sold (COGS) that constitute reductions to gross income (rather than deductions from taxable income), payments subject to US withholding tax, expenses in relation to financial derivatives, and payments potentially subject to the services cost method (SCM) under the services regulations. Consequently, there may be facts and circumstances that may require the characterization of certain intercompany transactions as outside the intended scope of the BEAT.

Services cost method

The SCM exclusion for the fully loaded costs of providing controlled services (but not the markup on those costs) from the BEAT numerator does not require that the taxpayer actually apply the SCM, but only that it conclude that the SCM could apply. This requires that the following basic requirements be met:

- The services are properly categorized

  either as "specified covered services" or "low margin covered services," but without regard to the so-called "business judgment test";
- The services are not excluded activities, such as manufacturing, R&D, financial transactions, or insurance; and
- The taxpayer retains adequate books and records supporting the application of the SCM.

As noted above, the SCM exception to the BEAT enables the taxpayer to exclude the fully loaded cost of controlled transactions from the BEAT numerator, which in many cases accounts for the largest portion of the charge for such services. Consequently, it is advisable for taxpayers to consider (or reconsider) whether specific services provided to US entities may qualify for the SCM exception.

Limitation on Business Interest

As part of tax reform, the US Congress also made substantial changes to Internal Revenue Code Section 163(j), which now restricts the amount of the interest deduction available to businesses to the sum of business interest income plus 30 percent of adjusted taxable income (ATI) for the tax year. This limitation has a broad impact on intercompany funding in the multinational banking sector. ATI is defined as earnings before interest, depreciation, and taxes (EBITDA) for tax years beginning after 31 December 2017 and before 1 January 2022. After 31 December 2022, the ATI is similar to earnings before interest and taxes (EBIT). Although there are some exemptions and exclusions, none are likely to apply to financial institutions. Consequently, the potential tax burden on banks located in the United States that receive intercompany funding from abroad may be substantially greater than in previous years.

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Brexit – Business Restructuring

As we know, the EU has granted the UK an extension of the Article 50 withdrawal date to 31 October 2019. Many UK-based financial services groups are well advanced in their contingency planning, having established new EU passporting entities and transferred existing branches in many cases in readiness for "Day 1". A discussion of the transfer pricing considerations and the question of potential "exit charges" on assets was included in our October publication.

Subsequently, HMRC have released a document entitled "Business restructuring as a result of regulatory change arising from EU Exit" (the "HMRC Brexit Commentary"). This article seeks to consider the transfer pricing aspects of this Commentary together with the principles discussed within Chapter IX of the OECD Transfer Pricing Guidelines. We have sought to illustrate this through examples.

Background

As a consequence of the Brexit Restructuring undertaken by financial services groups, a new or existing EU entity will start to conduct activity previously undertaken by a UK entity. An initial question is whether the transition of this activity from the UK to the EU entity should be regarded as resulting from:

- The disposal, transfer or realisation of any valuable assets, for UK corporation tax purposes, by the UK entity; or
- The provision of a service by the UK entity to the EU entity (for example, some form of referral), or some other arrangement between the two entities, which at arm's length would attract some form of consideration.

Our October 2018 article highlighted the UK tax rules that should be considered in relation to the disposal, transfer or realisation of assets (in particular, the Capital Gains and Intangible Fixed Assets ("IFA") regimes), and the different provisions regarding the application of an arm's length price versus a market value.

Arm's length price v market value

The distinction can be important and potentially lead to different results.

For both chargeable assets and IFAs, "market value" is defined as "*the price the asset might reasonably be expected to fetch on a sale in the open market*"[1].

On the basis that this refers to the "open market", the value must take into account what would be agreed between a hypothetical purchaser and vendor, who are unknown to each other and are participating in an unrestricted market. As such, particular circumstances of the buyer or seller cannot be taken into account in determining market value[2].

In contrast, arm's length value is the price which would be agreed between the actual parties to a transaction, if they were acting independently on their own account taking into account their particular characteristics and circumstances[3].

1 Section 845 CTA 2009 and Section 272 TCGA 1992

2 HMRC guidance is consistent with this - see Capital Gains Manual - CG16350.

3 This is supported by the HMRC guidance set out in Capital Gains Manual – CG14541

In the context of a Brexit-driven reorganisation, the market value of an asset may exceed its arm's length value. This is because, whilst arm's length value can reflect the weak bargaining position of a UK company which is being forced to dispose of an asset (e.g. due to a loss of permissions), market value does not. In an unrestricted market, prospective buyers might compete and drive the price upwards to beyond that which might be agreed at arm's length.

OECD Guidelines – Chapter IX – Business Restructuring

Chapter IX of the OECD Transfer Pricing Guidelines[4] focuses on Business Restructuring and addresses the application of the arm's length principle in cases where a business restructuring results in a reallocation of profits between associated entities. A business restructuring is defined as the cross-border redeployment, by a multinational enterprise, of functions, assets and/or risks, which may or may not involve the transfer of valuable intangible assets. It should also be considered where there is a termination or substantial renegotiation of existing arrangements, as could be the case in a Brexit scenario.

In relation to a business restructuring, Chapter IX first requires taxpayers to identify the commercial or financial relations between the parties which are most relevant to determining the arm's length conditions of the business restructuring. In particular:

- Identify the business restructuring transaction and functions, assets and risks before and after the restructuring;

4 The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations Chapter IX

- Identify the business reasons for and the expected benefits from the restructuring; and
- Consider the options realistically available to the parties.

Options realistically available

The concept of 'options realistically available' is based on the notion that independent enterprises will compare the transaction to the other options realistically available to them, and they will only enter into the transaction if they see no alternative that is clearly more attractive. An independent enterprise would only enter into a transaction if it does not make them worse off than their next best option.

A regulatory change resulting from Brexit meant that UK based Banks, Insurers and Asset Managers were likely not going to be able to service their EEA customer base post-31 March 2019. Given the uncertainty associated with Brexit and the ability to continue to provide these services, UK-based financial services groups in some cases made the decision to establish a new EU entity or use an existing EU entity to undertake these activities post Brexit.

This may take different forms depending on the sector; for example, the movement of management contracts in an asset management context, renewal rights in an insurance context, and trading books in a banking context. The precise form may also differ, for example, is there an actual transfer or novation of contracts, or simply a recommendation to clients to start doing business going forward with the new EU entity. These facts and circumstances will be the starting point for the above analysis.

As mentioned above, given the uncertainty as to the Brexit outcome on 29 March 2019, UK-based financial services groups considered the other options realistically available to them in each case, on the basis that their existing passporting rights would no longer be available post-29 March 2019. On the assumption that there was no actual transfer of existing contracts, illustrative examples of these options may include:

1. The UK entity could seek to refer customers to a different or third party provider; or
2. The UK entity could choose not to refer its customers to any party;

In relation to Option 1, consideration should be given as to whether a referral fee might be payable between independent parties.

In relation to Option 2, the UK entity would not receive any further revenue in relation to its existing EEA customers. While this may be a commercial outcome given the expectation that the UK entity would no longer be able to service its EEA customers post-29 March 2019, a rational entity might consider options, if available, to earn at least a fee from referring the customers to an entity that is able to provide such services.

The HMRC Brexit Commentary alludes to Option 1 in their commentary on "Other receipts in respect of an IFA", where they state:

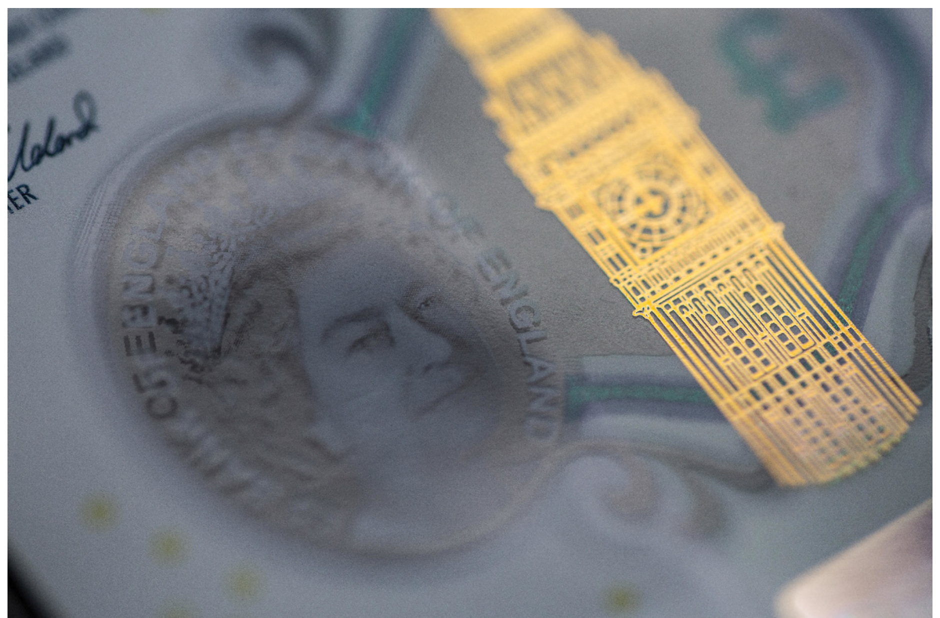
"In situations where there is no transfer or realisation of assets, customers would need to consider the application of the arm's length principle and whether this would result in any form of compensation or referral fee etc. due to the UK entity as a result of the proposed restructuring."

The IFA in this case could be the customer relationships.

Recognition of the business restructuring

Once the business restructuring has been fully delineated under the arm's length principle, it should be considered whether any adjustments to profits should be made in accordance with Article 9 of the OECD Model Tax Convention.

Chapter IX states that tax administrations should not disregard actual business restructurings or substitute other transactions for it unless exceptional circumstances apply. If conditions have been made or imposed in a business restructuring that differ from those that would be made between independent entities, the restructuring can be disregarded. However, this is relevant only if the actual restructuring is not commercially rational, and would not be agreed between independent parties in comparable circumstances, thereby preventing the determination of a price that would be acceptable to both of the parties taking into account their respective perspectives and the options realistically available to them. If a more profitable structure could have been adopted, but the actual structure adopted is commercially rational, the transaction is not disregarded. It is assumed that decisions relating to the establishment of a new EU passporting entity and any referrals from the UK entity to the EU entity were commercially rational, and therefore any such transactions should not be disregarded.



The UK's expected departure from the EEA on 29 March 2019 (notwithstanding the subsequent delay), arguably placed UK-based financial services entities in a forced situation that they would no longer be able to service their EEA customers. Therefore, in terms of bargaining power, the UK entity would not necessarily be in a strong position, rather in the position of a forced "seller". Any counterparty would appreciate this, and it would be a factor in a third party negotiation. This would therefore be a factor in determining an arm's length price, if any, in any such circumstances. The relative bargaining power of the respective parties is an important factor. A quantitative and qualitative assessment should be undertaken.

If it is considered after such analysis that a fee would be due for such a service at arm's length then a comparability analysis is recommended to determine a Comparable Uncontrolled Price. This should help benchmark an arm's length range for any such fee against either third party data (an "External CUP") or a comparable arrangement entered into by the Group with an independent party (an "Internal CUP").

Tax authority engagement

For groups requiring certainty, we are seeing examples already of the willingness of HMRC and European tax authorities to engage in potential Advance Pricing Arrangements ("APAs") to cover Brexit restructuring transfer pricing. It should be possible, subject to meeting the usual criteria for entry into the HMRC APA programme[5] to also include any potential referral fee pricing in addition to the transfer pricing for any post-Brexit intercompany arrangements between the UK and the EU entity.

5 Statement of Practice 02/10 as updated in November 2016

Revisiting transfer pricing in the alternative asset management sector

Introduction

It is time to revisit transfer pricing in the alternative asset management sector.

First, new concepts introduced by the Organization for Economic Cooperation and Development ("OECD") as part of the Base Erosion and Profit Shifting ("BEPS") initiative in 2015 – aimed at aligning taxation with the economic activity that generates profits – are fundamentally reshaping the international tax landscape. This positions transfer pricing as one of the most contentious topics in today`s tax environment. Specific to the asset management sector, the new principles embedded in BEPS Actions 8-10 require consideration of the appropriateness and defensibility of existing transfer pricing approaches, potentially affecting the effective allocation of management and performance related fees across the different functions of the business.

Second, the BEPS initiative has inspired many tax authorities around the world to follow their own interpretation of these new concepts. Scrutiny extends to formalistic aspects (i.e., appropriateness of existing documentation and support available) as well as material aspects based on the local tax authorities` own notion of appropriate substance, control over risk and financial capacity. Specific to the alternative asset management sector, we are seeing an increased level of scrutiny on transfer pricing across various jurisdictions focusing on the remuneration of different functions within the value chain; we have also witnessed attempts by some tax authorities to re-characterize carried interest and include it as part of a fee split. Going forward, this scrutiny is likely to include review by tax authorities of group's country-by-country reports, with the aim of identifying any potential mismatches between the jurisdiction(s) in which profits are recognized and the location of investment professionals.

Third, the interaction between the regulatory and tax dimension is becoming increasingly complex. This is especially valid considering the move in the alternative sector into regulated structures, for example, on the private equity side, and the resulting impact on existing operating and organizational models. The main impact relates to the insertion of an Alternative Investment Funds Manager ("AIFM") into the structure and the resulting changes to the operational set-up, substance and functionality of the different parties involved, changes to transaction flows, integrating the AIFM into key decision-making processes (such as investment committees) and the impact on the role of General Partners ("GPs").

In this article, we revisit recent transfer pricing developments for alternative asset managers and provide insight into key issues and important practical takeaways.

Impact of BEPS on sector-specific transfer pricing approaches

Transfer pricing for the alternative asset management essentially covers the question of how to split management and performance related fees across the key activities along the value chain covering:

- Capital raising and distribution/fund marketing;
- Deal-sourcing and investment advisory/ asset management (as well as property management in the real estate sector);
- Fund administration;
- Function of regulated AIFMs as well as unregulated GPs;
- Other support functions; as well as
- Activities related to the creation of potential intangibles (e.g., development of software, investment platforms or trading algorithms as well as marketing activities/ trademarks) and whether these should be revisited in the light of BEPS.

Historically, we can identify two main transfer pricing models that were typically adopted in the alternative asset management sector:

- Centralized models where the activities of the foreign-related parties are limited to routine functions such as investment research/advisory or distribution/ marketing related support activities that are remunerated based on a cost plus-type approach; or
- Integrated models based on a fee or profit split where foreign-related parties perform routine as well as non-routine functions (incl. portfolio management, capital raising, management/investment committees) and their remuneration is based on a share of the management and/or performance fees (or profits) based on appropriate allocation keys.

Whilst it is generally the case that the basic value chain of many businesses within the asset management sector is similar, the choice of a method that is appropriate to remunerate, for example, a distribution or investment advisory function is in practice quite complex. In addition, the nature of the asset class can often have an important influence on the transfer pricing approach. Typically it has been more feasible to apply centralized models within sectors such as private equity, where a relatively small number of large transactions occur and the decision-making role of the

investment committee can be seen as paramount, than, say, in other sectors such as hedge funds, where decision-making is necessarily disbursed (e.g., to locally based traders). Indeed, what have traditionally been fairly straight-forward pricing policies are now becoming far more complex as the recognition of new value drivers, greater split of fee flows, and additional cross border transactions are being recognized.

BEPS should be a trigger for any asset manager to revisit the appropriateness and defensibility of their transfer pricing models in light of the functions performed by the local affiliates and the potential value-added nature of these functions.

As further discussed below, considering the rise of AIFMD-regulated structures, alternative asset managers will also need to consider the addition of regulated AIFMs into their operating and transfer pricing model. It is important to remember that AIFMs play a unique role. Their functional profile can vary significantly, from a more limited profile where the AIFM typically focuses on risk management, oversight of delegated functions and compliance/reporting to a more fully-fledged profile where the AIFM also performs part or all of the investment management, distribution and fund administration related activities.

The common denominator of these models is that they often rely on a centralized operating model where there is one regulated entity (i.e., the Management Company/AIFM) engaging with a number of related (or unrelated) parties across a range of jurisdictions linked to the activities that are being delegated. One of the key tax-related concerns related the cross-border delegation model is that all transactions flow back to the Management Company ("ManCo")/AIFM, which in practice can cover a large number of jurisdictions and even greater number of transactions. In case of any transfer pricing audits and resulting adjustments, the Management Company ("ManCo")/AIFM would thus be the counterparty to such transactions that could result in double taxation and/or penalties.

Rise of regulated structures

According to the Financial Times, "private equity will overtake hedge funds as the largest alternative asset class within the next five years". The total assets under management in alternative classes - which includes hedge funds, private equity and real estate funds - are expected to increase by almost 60% to USD 14tn by 2023[1].

An increasingly large share of the additional assets raised, especially by private equity firms, are for funds (i.e., private equity, real estate, venture capital and debt) which are regulated under the Alternative Investment Funds Manager Directive ("AIFMD"). It is possible that regulations such as the AIFMD are only part of a larger global regulatory and secular trend towards more risk-based regulations where regulators (and potentially investors) demand for more robust risk management and transparency.

1 Financial Times, 24 October 2018, https://www.ft.com/content/715fda20-d6ff-11e8-a854-33d6f82e62f8

Due to the fact that until recently many alternative asset managers were rather lightly regulated, many players in the alternative sector may face significant challenges and changes to their organization and operational models.

In summary, alternative fund managers must have appropriate, documented and updated due diligence policies and procedures. In addition, managers must have adequate systems to identify, measure and monitor all relevant and major risks associated with the fund manager's strategy and to which a fund may be exposed, especially if operating under regulated fund regimes.

Three of the key ramifications from the introduction of AIFMD-regulated structures that may impact transfer pricing considerations are:

- Introduction of transparency/reporting requirements and risk management requirements. In particular, many private equity and other alternative fund managers have not historically had the functional and hierarchical separation of the risk management and portfolio management functions required by the new legislation;
- Requirements for the regulated fund to be managed by an Alternative Investment Funds Manager ("AIFM") which will be responsible towards investors and regulators. In addition, the AIFM will also be responsible for risk management, oversight, compliance as well as needs to be involved in key-decision making functions such as the investment committee; and
- Limitations on remuneration of senior management

From a transfer pricing perspective, one of the key challenges arising from the above will be to develop an appropriate transfer pricing approach to remunerate the new role of the AIFM based on the functions and risks that it is required to assume from a regulatory standpoint and which it actually assumes. Where the role of the AIFM goes significantly beyond a mere regulatory management function (focusing on risk management, oversight of delegated functions and compliance/ reporting) to a more fully-fledged fund manager profile, the transfer pricing analysis (particularly in light of BEPS) may make it more likely to follow an entrepreneurial revenue/profit profile – i.e., one that involves the AIFM assuming more significant commercial risks. This may have potential to cause friction with regulators, who may feel more comfortable with an approach under which there is greater certainty with respect to revenues/profits.

Furthermore, since the insertion of the AIFM will impact both the overall organization and operational set-up of the fund manager group and transaction flows (since it is the AIFM that will often need to delegate portfolio management, capital raising and other functions and be the legal counterparty to such transactions), it may also be necessary to reconsider the consequential impact on other parties. For example, if the AIFM performs regulated fund management functions, the role of the fund general partner(s) may be limited to only (what could be best described as) legal oversight. If this were the case, it may require some alternative asset managers to revisit the current role and remuneration approach for their general partner(s), to the extent this is distinct from day-to-day advisory and similar functions.

Tax authorities and regulators

Industry experience and technical expertise in the asset management sector is varied across tax authorities. As a result, in our experience, certain tax authorities have relied on rather formalistic criteria (i.e., whether reasonable efforts were made to document the arm`s length nature of transactions, the non-documentation of certain transactions, the non-recognition of a permanent establishment or the lack of sufficient cooperation under audit) as basis for their assessments invoking presumptive taxation. Other tax authorities in the past decided to focus on less complex transactions such as the provision of intra-group services instead. Nonetheless, this is likely to change in the future as tax authorities globally are gaining more experience across the industry.

Transfer pricing has, and will continue to be, a key area of focus for tax authorities globally. BEPS Action 13 specifically addressed the topic of transfer pricing documentation and shows the consensus of tax administrations globally to establish minimum standards for disclosure and transfer pricing documentation (based on the master file, local file and country-by-country reporting framework). Many countries have already implemented BEPS action 13 in their domestic legislation, not only covering documentation standards but also dealing with specific domestic exemptions, thresholds, timing and penalty regimes.

Given the potential impact of tax audits and resulting controversy within the sector, both tax authorities as well as financial regulators are currently focusing on tax as a governance topic. We are witnessing a substantial increase in information requests from tax authorities globally as part of or even outside their regular tax audits to gauge the readiness of asset managers.

For example, in mid-2018, the tax authorities in Luxembourg contacted a range of asset managers in Luxembourg to request support that any intra-group transactions adhere to the arm`s length standard and as such probe how well-positioned asset managers are with respect to transfer pricing as part of their tax governance. At the same time, financial regulators have also started to focus on tax as an indicator of proper management of regulated entities as part of their inspections and on-site visits. This shows that both tax authorities and financial regulators recognise the importance of pro-actively managing tax risk and the impact on the asset management sector.

Practical implications

Taxpayers will need to respond to the challenge by considering the following key questions:

- Are transfer pricing policies in place and are they consistently implemented?
- Are the transfer pricing policies applied defendable in light of BEPS and any recent functional changes that may have occurred as a result of regulatory factors (especially the move to AIFMD-regulated structures)?
- How is the role of the ManCo/AIFM remunerated in case of AIFMD-regulated structures?
- What is the impact of the group's transfer pricing policies on its country-by-country report, in terms of the jurisdictions in which profits are recognized and how this compares with the profile of where investment professionals are based?
- Is appropriate transfer pricing documentation in place and are the functions and risks as described within this documentation consistent with the regulatory characterization of the various entities?

- How can the existing transfer pricing and legal documentation be improved as a first layer of defense against potential tax audits?
- Is the ManCo/AIFM involved in the process of setting the tax strategy and tax risk management?
- How are tax audits being managed to avoid potential global inconsistencies in the overall transfer pricing model? Are management of the Manco/AIFM involved in any audits/controversies within local markets (bearing in mind that the Manco/AIFM would often be the transacting counterparty under a centralized operating model)?
- Is management aware of the options available to manage tax audits/controversies ranging from domestic appeals, MAP and/or APAs (e.g., as "lighthouse" APAs that can be used as a base to support the transfer pricing positions towards tax authorities in other jurisdictions)?

Conclusion

The discussion shows the complexity of transfer pricing for the asset management sector given the range of operating models and trends. The BEPS initiative had a major impact on the applicability and potential defensibility of existing transfer pricing approaches. The remuneration of captive regulated AIFMs is a complex issue that needs to be carefully considered in the transfer pricing model. It is also essential that any analysis is aligned with the regulatory dimension given the critical interaction between both dimensions on aspects of substance and control over risk. An increasing number of regulators are currently looking into transfer pricing as an indicator of proper management of the AIFM so the topic is not only relevant for tax professionals but also for management at the level of the AIFM itself.

Charging for technology in the banking industry

While banks have always had significant technology expenses, technology has traditionally been viewed as a necessity to run the bank, i.e., providing the required infrastructure to effectively deliver banking services and stay abreast with the market, rather than a competitive advantage that will build the bank. On this basis, intra-group information technology ("IT") charges in the banking sector to date have been more suited to Cost Plus or cost contribution arrangements transfer pricing methodologies. This article considers technology's evolving role in the industry value chain and the transfer pricing methods that are potentially applicable to charging for technology, including relevant considerations for each of the methods.

State of play in the industry

Technology is changing the banking industry more rapidly each day. Mobile banking software, robo-advisers, algorithmic trading models and brokerage platforms to facilitate direct market access are just some examples of advancements that have become the new norm in the industry.

On one hand, banks face heightened expectations, as consumers and corporates alike demand accessibility, ease-of-use and more instantaneous service. On the other hand, technology presents potential opportunities to reduce costs, increase revenues through the use of data and alleviate compliance burdens imposed by regulatory requirements. There is increased competition with growing numbers of "fintech" entrants in the market and technology companies offering alternate banking models, aided in part by proprietary technology, and in part by digital access to new sources of capital such as crowd-funding.

At the heart of the transfer pricing analysis are questions of identity (or functional characterization): Is the bank evolving into a technology company, at least in part? Or does it continue to be a supplier of financial services, using technology as a driver, but one that still ranks behind its highly skilled personnel and access to capital?

The selection of the most appropriate transfer pricing method will necessitate an evaluation of whether technology constitutes a key driver within the value chain of the bank. Further consideration will be required as to whether the group IT services have resulted in the creation of an intangible asset, requiring separate remuneration, for example via a licensing fee or royalty.

Assessing the transfer pricing methods

Cost Plus

As indicated above, IT services have traditionally been viewed as a non-core contribution within the banking industry, remunerated on a cost-plus basis with a modest mark-up. This view was confirmed by the inclusion of IT services (not forming part of the group's principal activity) within the OECD's low value-adding intra-group services guidance.

A close review of this guidance shows its applicability is limited to activities that do not create profit or are not economically significant to the group[1]. Where a functional analysis concludes that the IT services represent a unique and valuable contribution to the group, or are highly integrated into the core offerings of the bank, then a cost plus method may not be suitable.

1 OECD 2017 Transfer Pricing Guidelines, paragraph 7.45

Many banks have shared service centers with IT developers that undertake software development in low labor cost jurisdictions ("contract R&D services"). These entities are also typically remunerated via a cost-plus methodology on the basis that no decision making or strategic input is performed in these locations, and the activities undertaken are not unique and may equally be outsourced to third party developers.

Consideration should be given, particularly in a post-BEPS environment, as to an appropriate reward for development, enhancement, maintenance, protection and exploitation ("DEMPE") functions, even where the control of such functions resides elsewhere, and whether the role of the contract R&D service provider may evolve over time to include the making of strategic development decisions. The OECD's guidance[2] indicates that there are instances where a Cost Plus method with a modest mark-up may not reflect an arm's length return for contract R&D services, citing unique skills and experience, assumed risks, use of existing intangibles, and control/management as relevant factors to consider.

As tax authorities place further scrutiny in this area, the ability to segregate between value driving technology and back-office infrastructure support will become a key focus. With many jurisdictions requiring clear evidence of the benefit created by an inbound charge before allowing a deduction, banks may argue that the service is instrumental to the business, and often connect it to revenue generation. However, such arguments may provide a rationale for the charging jurisdiction to contend that the services are high value, requiring additional remuneration. In this sense, the characterization of technology spend as revenue driving, while helpful for deductibility, could potentially be a double edged sword.

2 Ibid., paragraph 6.79

Cost Contribution Arrangements
The OECD defines a cost contribution arrangement ("CCA") as:[3]

> …a contractual arrangement among business enterprises to share the contributions and risks involved in the joint development, production or the obtaining of intangibles, tangible assets or services with the understanding that such intangibles, tangible assets or services are expected to create benefits for the individual businesses of each of the participants.

Under a CCA, participating entities make balancing or "net" payments to one another to align their contributions (historically these are usually measured at cost) to the value of the benefits that they will receive. In practice, this significantly reduces the volume of intra-group recharges from the full costs incurred by the participants to the net payments required under the CCA. As such, where multiple group entities are performing technology related functions, CCAs may be useful in decreasing the administrative burdens and operational risks associated with large and frequent cross border charges, and the subsequent requirement to settle these charges. Joint contributions toward the development of any intangible assets also gives weight to the concept of shared economic ownership, arguably reducing the need for royalties or license fees between group entities. CCAs may also be particularly attractive to multinationals with operations in the US, as the proposed regulations to implement aspects of the US tax reform confirm that the Base Erosion and Anti-Abuse Tax ("BEAT") only applies to the net portion of platform contributions (buy-in payments) and cost-sharing transactions (balancing payments) for qualifying cost sharing arrangements.[4]

3 Ibid., paragraph 8.3

4 Proposed Treas. Reg. 1-59A-3(b). By way of background, the 2017 Tax Cuts and Jobs Act added Section 59A to the US Tax Code which imposes the BEAT ("Base Erosion and Anti-Abuse Tax") to certain taxpayers that make payments such as royalties, interest or other fees to a non-US related party. Broadly speaking, the BEAT is a minimum tax calculated on a taxpayer's taxable income determined without regard to expenses that are considered to be "base eroding" at a rate of 11% (for banks and securities dealers) for tax years beginning in 2019 through 2025.

It should be noted that the 2017 version of the OECD Transfer Pricing Guidelines contains significant revisions to the guidance on CCAs, including the new concept of assessing contributions "at value". While the revised guidelines indicate that it may be appropriate for contributions to be made "at cost" in certain circumstances, banks with CCAs that pre-date 2017 are advised to review their arrangements and consider if the economics thereunder would change based on an application of the latest OECD guidance. There are also stronger thresholds for CCA participants to evidence "control over risk", in line with the principles contained in the BEPS Actions 8 to 10 report. Such controls are designed to ensure that each participant is properly considering the charges received under a CCA and ensuring this is proportional to the benefits it receives.

Comparable Uncontrolled Price
Where group IT development activities create an intangible asset, a licensing fee for the use of the asset by other group entities may be appropriate. Where a multinational does not license its technology to or from third parties, the application of the comparable uncontrolled pricing method would involve identifying licensing arrangements between two independent parties for similar types of technology. Such a licensing arrangement may be priced on a 'fee per user' or 'percentage of sales' basis.

This pricing method has traditionally been more prevalent in the life sciences, manufacturing and TMT[5] industries, where technology has long been recognized as a key driver in the value chain, with the value of the intangible assets often linked to registrable IP such as long dated patents. Conversely, with certain limited exceptions in the retail banking sector, a charging method that is not tied to cost has been relatively rare in banking. Instead, value has historically been placed on customer relationships, personnel skills and the all-important access to capital and funding. Technological advancements in banks, combined with the arrival of new entrants such as fintechs and technology companies offering novel banking and payment processing solutions, make it harder to maintain the historical delineations. Should there be a distinction between digital-only banks, and traditional banks that have introduced digital offerings in response to competition?

Profit Split

The OECD recommends the use of a profit split methodology when two or more parties are making unique and valuable contributions to the value chain or where the parties engage in highly integrated activities.[6] While the use of revenue and profit splits are prevalent in the banking and capital markets sector, split factors have typically comprised "capital" and "people functions". The adoption of a profit split methodology with the inclusion of technology as a split factor would signal recognition by the bank applying this methodology that technology is creating value that lasts beyond the current period and is deserving of remuneration beyond a routine cost-plus return.

5 Technology, Media and Telecommunications

6 OECD 2017 Transfer Pricing Guidelines, paragraph 2.4

Assuming the profit split is the most appropriate method, the strength of this transfer pricing method, in particular the residual profit split variant, is its flexibility, and the possibility of delineating and remunerating contributions across: (i) the control of the intangible assets, which may facilitate a centralized ownership model for commercial protection purposes and enable access to development incentives; (ii) the usage of the assets; and (iii) services performed in developing or enhancing the assets. Under this method, the charge for technology would also be more commensurate with the resultant revenues or profits, as compared with a charge computed based on the cost plus method. In addition, the appropriate inclusion of technology as a profit split factor would arguably provide sufficient remuneration to any intangible assets created, and thus a separate licensing fee may not be required.

The downside of the profit split method is its complexity, as compared with the other transfer pricing methods discussed above. However, by selecting the right drivers and valuing these appropriately, risk and reward are potentially better aligned within the organization. Further, given the novelty of this approach in the banking sector, the application of this method would need to be supported by a thorough and robust functional analysis.

Taxation of the digital economy

The growth of tax policy on the taxation of the digital economy, including the introduction of a "digital service tax" by some jurisdictions, shines a spotlight on the role of technology in the value chain of an organization, and banks are not exempt from the additional scrutiny that may result from this development.

The OECD's paper "Addressing the Tax Challenges of the Digitalization of the Economy – Policy Note", released in early 2019, highlights the disruptive impact that digital services have had on the existing international tax framework and explores potential solutions for how taxing rights on income generated from cross-border activities should be allocated in the digital age. The potential solutions discussed include attempts to better recognize the value in user participation, which requires revisiting well-established principles such as nexus tests, profit allocation rules, and extending sourcing rules to include significant economic or digital presence.

This change has seen tax authorities globally move to consider the impact on their respective tax bases. Jurisdictions with senior personnel will likely want to see remuneration for the control of DEMPE functions, while countries with highly skilled software developers will be keen to see the importance of these activities recognized. Meanwhile, jurisdictions which are largely consumers of the products and services may now look to establish the value of user participation, particularly where data is seen to be a driver of value and future revenues.

In summary

Advancements in the banking industry, the arrival of tech-savvy entrants in the market, the focus on intangible assets post-BEPS and the development of tax policy on the digital economy collectively result in a need for banks to consider the role of technology in their respective value chains, and make an assessment as to whether their current transfer pricing policies need to be adapted to reflect technology as a key value driver. To do this, an in-depth understanding of the strategic priorities of the bank is required, as this will be critical for selecting the correct transfer pricing model.

Technology disruption in the insurance sector - transfer pricing implications

Introduction

The global insurance sector has undergone an immense overhaul because of disruptive technologies in recent years, alongside ever increasing demand for new offerings. Each participant in the insurance value chain, from distributors, brokers, insurance carriers, claims handlers and a network of service providers, are seeing a rise in the exploitation of technology to maintain pace with their peers.

The technology being used ranges from:

- Mobile applications enabling consumers to purchase insurance on-the-go;
- Data analytics for insurance brokers;
- Smart contracts issued by insurance carriers on an algorithmic basis; and
- Machine learning to drive automated claims handling and processing systems.

Taken together, these capabilities have provided a number of opportunities for participants to improve their competitive advantage in the market by retaining customers and improving customers' experience. To drive their technology development, many groups are establishing centres of excellence or innovation hubs, which brings a radical shift in operating models and poses multiple transfer pricing and tax considerations.

From a transfer pricing perspective, there are two fundamental questions to be addressed which are:

1. Should there be a transfer pricing charge for the use of the intangibles underpinning the new technology developed elsewhere in the Group?; and if so,
2. What would be an arm's length charge for the exploitation of the intangible?

This article is focused on considering these questions in further detail.

What are the intangible assets for transfer pricing purposes?[1]

The first question that any transfer pricing professional should be asking in this new world of technology is, what are the intangibles assets being used; only after that question is answered can one address the issue of what value is attached to them?

The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("**OECD Guidelines**")[2] define an intangible[3] as something:

1. that is not a physical asset nor a financial asset;
2. that is capable of being owned or controlled for use in commercial activities; and
3. whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances.

For technology, therefore, components such as source code and algorithms would fit within this definition, the idea of using a mobile app for on-the-go insurance sales would not.

1 Paragraph 6.6 of OECD Guidelines
2 Released in 2017.
3 Please note that "intellectual property" or "IP" is a form of intangible, but not all intangibles are IP.

Evidencing value – should there be a charge at all?

Once it has been established that the technology (e.g., the software in a mobile application facilitating the sale of insurance or predictive pricing analytics system) meets the definition of an intangible asset for transfer pricing purposes, the next key question is whether a third party would pay for its use. The software is "copyright" and therefore the creator has a legal right to prevent others from using it. This "negative right" for monopoly of use is then the basis of all licenses, which are "payments for non-exercise of my right to prevent you". So a license is needed, but the quantum of the license is driven by the economic benefit that other Group members achieve by using the intangible. This is key in determining whether there should be a material charge at all to other affiliates in the Group that use and exploit the intangible asset in their local markets.

An intangible is valuable because it can be turned into cash in the market place. That might be from increased prices or volume of sales, or reduced costs, or by creating a barrier to entry to a market place. When it comes to attributing value to intangibles, often it is easier to see how value is added, and then to quantify it, in some industries than others. Pharmaceutical groups can point to cash flow from drugs. Fashion houses can cite increased profitability through design labels over generically branded goods. Algorithmic traders can look at trading profits generated by the code or the trading system. However, in an insurance context, this proves to be challenging, but it is a critical step. If an intangible directly leads to increased sales, improved prices or reduced costs (e.g., automated policy issuance under smart contracts), this can be simple enough. But

what if the intangible is an internal data analytics platform which is used for internal purposes only, and management points to factors such as increased customer retention or satisfaction, or freeing up internal resource (e.g., through reduced time spent on administrative activities) as its perceived value? Finally, are the intangibles recognised on the balance sheet for accounting purposes?

In these situations, taxpayers can encounter difficulties in evidencing value and in this instance, it is essential that quantitative measures are used to do so, or it can be challenging to justify a charge for the use of such intangibles to the satisfaction of a tax auditor.

Where it can be established that the intangible asset has value and that it provides an economic benefit to other group affiliates, we can establish a price for a license to be paid for use of the intangible. That license fee is always paid to the legal owner of the intangible (we have established that the payment is for non-exercise of the legal right to prevent use, and only the "legal owner" has that power). However, Chapter VI of the OECD Transfer Pricing Guidelines recognises that where entity(ies) other than the legal owner undertake (at least some part of) the development, enhancement, maintenance, protection and exploitation ("**DEMPE**") functions and associated risks then they must be paid. In this way the overall reward earned from the intangible might be shared amongst (possibly several) group companies.

DEMPE analysis

Historically, businesses have relied on the legal ownership of intangibles (e.g., of copyrights and patents) as expression of their property rights, and the OECD Guidelines state that generally, the legal owner of an intangible has the exclusive legal and commercial right to use the intangible, as well as the right to prevent others from using the intangible[4]. However, Action 8 of the OECD's Base Erosion and Profit Shifting ("**BEPS**") project, which is incorporated into Chapter VI of the OECD Guidelines, did not change the party to whom the license fee is paid (i.e., the legal owner) but emphasised the need to consider contributions to DEMPE functions by another entity (or entities) within a multinational enterprise (**"MNE**"), and to assess how these contributions should be paid for. The 2017 OECD Guidelines provide a "six-step approach"[5].

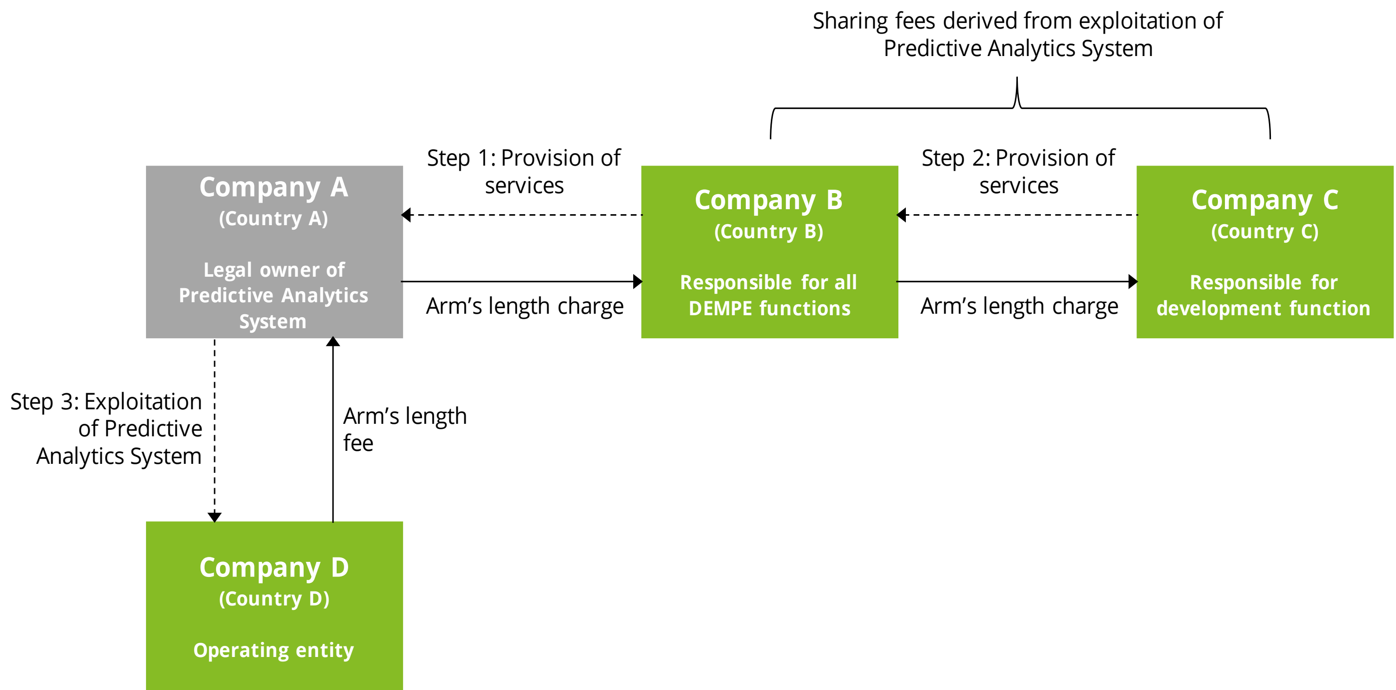
Under this six-step approach, by way of secondary transactions the party or parties performing functions, using assets and managing risks in a DEMPE context are entitled to the majority of the profit generated for the Group by the intangible in question. To arrive at this result, the actual transaction(s) between the legal owner and those performing DEMPE functions is "delineated" based on the contracts and the conduct of the parties, and priced. Legal ownership, in the absence of any DEMPE functions, might not lead to a retention of profit from the license by the legal owner other than arm's length fee for holding the bare legal title[6].

4 Paragraph 6.37 of OECD Guidelines
5 Paragraph 6.34 of OECD Guidelines
6 Paragraph 6.42 of OECD Guidelines

Many tax authorities have embraced this approach, particularly as it presents the opportunity to potentially look at arrangements which could, if accurately "delineated" allocate additional income to locations where many MNEs have a significant onshore presence. As such, tax authorities are actively challenging taxpayers in audits by undertaking DEMPE analyses across global value chains of MNEs in order to ensure that the transfer pricing outcomes are in line with value creation as articulated in the 2017 OECD Guidelines.

A recent example of disruptive technology in the insurance industry may relate to predictive analytics systems which use statistical algorithms to analyse historical data to forecast future outcomes and inform the pricing of insurance contracts.

The below diagram sets out an example of how the intercompany flows and activities may be split within a group where two or more entities are jointly responsible for developing the predictive analytics system.



Step 1
Based on the above example, Company A is the legal owner of a predictive analytics system but outsources the performance of DEMPE functions entirely to Company B.

As such, although Company A is the only one that can license Company D to use the intangible and Company D pays a license fee to Company A, as Company A did not itself perform all of the DEMPE functions it must pay Company B an arm's length fee for its contribution to DEMPE activities. Net of this second payment the return earned by Company A might be no more than an arm's length fee for holding the legal title, with the remainder of the intangible related returns being paid to Company B under the secondary transaction.

Step 2
Company B is responsible for performing or overseeing all DEMPE functions with respect to the predictive analytics system. It outsources certain development functions to Company C.

Company C acts as a provider of development services and works in a close partnership with Company B in a way that sets it apart from a third-party contract services provider (for example, Company B does not control the activities of Company C in the way it would a true third-party service provider).

As such, the fee paid by Company B to C will not be a simple "Cost-plus" and will result in Companies B and C splitting the returns derived by the Group from the exploitation of the predictive analytics system on the basis that these companies jointly contribute to the DEMPE functions. In this case, the level of split will depend on the importance of their relative contributions to the earning of the income.

Step 3
Company A provides Company D with the right to exploit the predictive analytics system in return for the payment of an arm's length fee (e.g., a licence fee).

In turn, Company D uses the predictive analytics system to analyse historical data to forecast future outcomes and inform the pricing of insurance contracts and its profitability (net of the license fee paid to Company A) increases.

Pricing – What is an arm's length charge?

Once a taxpayer has identified intangibles which are relevant for transfer pricing purposes and are satisfied that a third party would pay for their use, the next step is to consider the basis under which to establish an arm's length charge. As noted above there might be a single transaction to price (where the intangible owner also performs all DEMPE functions) or there might be secondary transactions to take into account (where DEMPE functions are performed by other members of the Group).

As summarised in the table below, there are various options in terms of charging models to deal with the first transaction. Whilst each model can produce similar transfer pricing results, the associated indirect tax treatment of each charging model can vary. It is important to undertake a detailed feasibility study of the various charging models considering both the direct and indirect tax implications, in particular Value Added Tax ("VAT") or Goods and Services Tax ("GST").

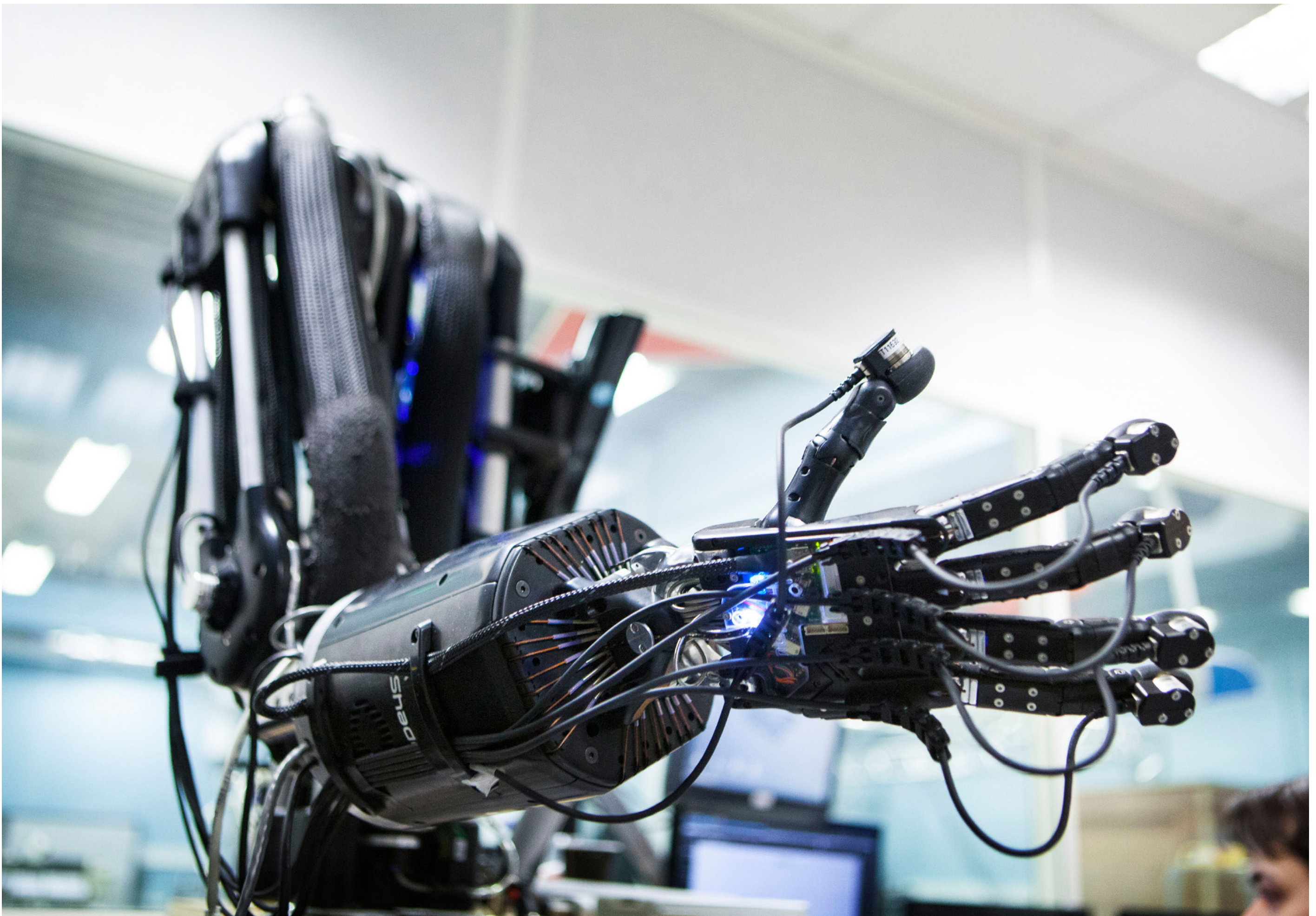
Proposed Charging Models for Intangibles

Proposed Charging Models	Licence Fee	Service Fee	Network Fee
Basis of Intercompany charge	The Licence Fee is most commonly expressed as a percentage of revenues generated by the Licensee.	The Service Fee may be a standalone charge structured on a cost plus basis or it may be embedded within existing intercompany charges (e.g., a network fee). A service fee is possible only if the owner of the intangible asset provides an intra-group service rather than simply making the intangible available.	The Network Fee is typically a bundled intercompany charge comprising of non-unique services (e.g., support services) and intangibles, which is often expressed as percentage of revenues. It may be the case that such a fee is structured on a sliding scale depending on the revenues generated and the benefit received by the Licensee/recipient.
Transfer Pricing Considerations	Under this approach, the intercompany charge is relatively simple to implement and calculate, as it is a function of revenues generated. The key transfer pricing question would arise in the Licensee jurisdiction if the overall return earned by the Licensee after payment of the Licence Fee is below an arms' length return; the user of a license would need to benefit.	The implementation of a cost plus model will provide a level of comfort to the tax authority of the user of the intangible in terms of the level of reward received. However if there is no causal link between the costs of an intangible and its value it is unlikely that a cost plus return would be acceptable – without further support – to the tax authority of the intangible owner, or to the tax authorities of those performing DEMPE functions.	Whilst the bundling of charges provides administrative simplicity, it is often the case that in transfer pricing audits, a tax authority would look to unbundle the charge and transfer-price each of the individual components separately. A similar exercise could be relevant from a VAT perspective. The implementation of a sliding scale is seen as favourable by tax authorities on the basis that the Licensee/recipient pays for such charges based on usage and the benefits derived. However, it should be noted that establishing the thresholds and tiers of pricing is often a difficult exercise and provides another area of potential challenge for a tax authority.
Potential Transfer Pricing Method to Support Intercompany Charge	It is unlikely that the Comparable Uncontrolled Price ("CUP") method can be used to establish an arm's length range of Licence Fees, unless the same intangible is licensed to third-parties by the Group or there are alternative systems available for license that provide the same benefit. It is more likely that a profit split will be used. The analysis must consider both the perspective of the intangible owner and the Licensee.	The transactional net margin method ("TNMM") may be used to benchmark the level of mark-up applied or the overall level of profitability of the Licensee after payment of the services, on the assumption suitable comparable companies can be identified. Care should be taken here; if the comparables do not have access to the same kind of intangible then the return should be higher than that of the benchmark entities; the user of a service does so to improve its own return.	For a network fee, certain components may be benchmarked using the TNMM method or a CUP approach, whilst similar to the Licence Fee it may also be corroborated with a profit split.
Other Tax Considerations	The implementation of Licence Fee or Service Fee has potential VAT/GST implications in both locations.		

As noted in the table above, in defending an intercompany charge for the use of intangibles, it is relevant to consider a two-sided transfer pricing analysis in line with the OECD Guidelines from both the perspective of the licensee and the licensor. Where external CUP analyses are performed, the comparability factors are heavily scrutinised by tax authorities. Intangibles by their very nature are unique, but the analysis must consider whether there are alternatives that can be used instead of the actual intangible. If so then external CUPs might be available, but if not then it is unlikely that a taxpayer would be able to find sufficient comparability when looking at transactions on a commercial database (to this end see the concurring judgement of Shepherd in the United States Court of Appeals, Eighth Circuit [2018] case Medtronic, and the UK House of Lords case General Tire & Rubber Co. v Firestone Tyre & Rubber Co. Ltd. [1975]). As such, it is often the case a CUP analysis where comparability is difficult to evidence is expected to be corroborated with an alternative method, e.g., profit split.

Summary

The transfer pricing of intangibles is a complex area and at the heart of much transfer pricing controversy. Participants in the insurance value chain have historically not considered intangibles in great detail. However, as operating models change with technology an intrinsic part of this, transfer pricing professionals need to (a) consider whether intangibles exist in the first place, (b) whether a charge should be made, (c) if so, the basis of such a charge, and (d) whether other members of the Group have contributed to DEMPE functions and should share in the rewards earned from the intangibles. The OECD, the G20 and tax authorities continue to focus on intangibles and it is important that insurance MNEs do the same.



Transfer pricing & VAT – Interaction

The importance of taxpayers giving consideration to the Value Added Tax ("VAT") implications of inter-company transactions priced in-line with transfer pricing ("TP") principles is increasing. Tax authorities are, with greater frequency, focussing on the indirect tax implications of TP policies and their implementation.

This article considers three key areas in which TP and VAT interact:
1. Transfer Pricing Adjustments;
2. Transfer Pricing Documentation, particularly in respect of the way intra-group transactions are described; and
3. Cost Contribution Arrangements ("CCAs").

Transfer Pricing Adjustments

There are many different forms of TP adjustments, some of which have VAT consequences that need to be considered.

TP adjustments can broadly be split into three categories:
1. Those that are made during the year – These could include true-ups that are applied for period 13 adjustments and could either be positive adjustments, or potentially negative ones.
2. Those that are made in tax returns – These could be self-assessed adjustments made to the tax returns reflecting the fact that the statutory books and records did not fully reflect arm's length pricing on some intra-group flows.
3. Those that are made following tax authority adjustment or agreement – These could include those that result from an enquiry, those that may result from the application of a TP method agreed under an Advance Pricing Agreement (where that is on a go-forward basis, or any roll-back period), or even those that are agreed following a successful Mutual Agreement Procedure claim.

From a VAT perspective, the starting position is that the value of a supply of goods or services includes everything received by the supplier from the customer (directly or otherwise) in return for the provision of the goods or services concerned.

The VAT implications of a TP adjustment will initially be driven by whether the adjustment reflects consideration made for a supply between the entities, and if so, whether that supply is taxable therefore giving rise to a VAT liability.

Generally speaking, for VAT there is not a requirement for the value of a supply to reflect the market value of the goods or services provided. However, this is not the position regarding transactions between connected parties, in which case anti-avoidance provisions can apply which require the value of the supply to reflect the open market value of the transaction, where it is not nil.

As noted by the European Commission's VAT Expert Group in their paper published in April 2018 on the "Possible VAT Implications of Transfer Pricing", there is a potential tension between the TP principle that transactions should be at an arm's length and that consideration for VAT is, typically, the price paid.

In assessing the VAT impact of the three adjustment categories set out above, it is important to note that the adjustments that are reflected purely through a tax return adjustment (items 2 and 3) may not give rise to additional/reduced consideration. Therefore, it could be argued that such an adjustment does not create consideration or indicate a change to consideration previously paid and so no additional impact on the value of the consideration paid for VAT purposes. Item 1, being an adjustment that is recognised in the accounts, is however likely to represent additional or reduced compensation for services.

Where the TP adjustment does result in additional/reduced consideration, the liability and subsequent input tax deduction right needs to be considered. Consistency of the VAT liability of supplies across the EU and globally cannot be assumed, and the ability to recover all or a proportion of the input VAT arising is very much driven by the methodologies in different territories.

Transfer Pricing Documentation

The level of information available to tax authorities has never been greater. As countries around the world have largely implemented the OECD's recommended standard for TP documentation (e.g., Master and Local Files), the level of information available on intra-group transactions is no exception.

As we all know, the OECD requirements for Master and Local File documentation include value chain information, business models, functional profiles, etc. The question is, however, have we considered whether an indirect tax specialist, reviewing the description of transaction flows contained within these documents, could form a view as to the VAT treatment on the flows that is different to what has actually been applied?

The first step is to determine whether each of the transaction flows disclosed in the TP documentation can be identified as single or multiple supplies for VAT purposes. A greater level of detail provided by taxpayers within their TP documentation should assist with undertaking any such analysis.

However, it is important that the position set out in the TP documentation is consistent with the facts as they are understood from a VAT perspective to mitigate the risk of any conflicts which could arise in the future. Such considerations should be performed in the context of the published guidance available as well as the case law principles established on this point.

Following that, the VAT liability of the supply, or supplies, identified should be determined. Again, the information contained within the TP documentation is likely to set out, to some extent, the nature of the services being performed and should therefore be reviewed to ensure it is in line with the VAT treatment determined of the supply or supplies being made. Master and Local Files which describe services generally, giving little detailed information and leading towards generic service descriptions, can prevent exemptions being identified and may also prevent appropriate allocation of costs to specific activities, therefore making correct application of VAT recovery methodologies difficult. Therefore, whilst an approach to standardising your TP documentation across multiple jurisdictions may be a sensible approach to reduce administrative costs, it could also result in unforeseen VAT implications or inconsistencies based on the local application of rules.

Cost Contribution Arrangements

A true cost contribution arrangement ("CCA") is the result of contractual obligations entered into between multiple parties where they are anticipated to share in the benefits and costs arising either (i) from the development of something of value, e.g., intellectual property ("IP") or (ii) the execution of services. As noted in the OECD Guidelines:

> In accordance with the arm's length principle, at the time of entering into a CCA, each participant's proportionate share of the overall contributions to a CCA must be consistent with its proportionate share of the overall expected benefits to be received under the arrangement. (OECD Guidelines, 8.5)

The consequence of this is that, in scenarios where one party's contribution is greater than the benefit they are likely to receive, then they are required under TP rules to charge the other parties to the CCA for their 'excess' contribution. If the contribution between the parties can be considered proportionate to their share of the benefits then no intra-group transactions will arise. However, how does this approach work when we are trying to calculate VAT liability? What is the 'value' of any transactions that we are trying to apply VAT to?

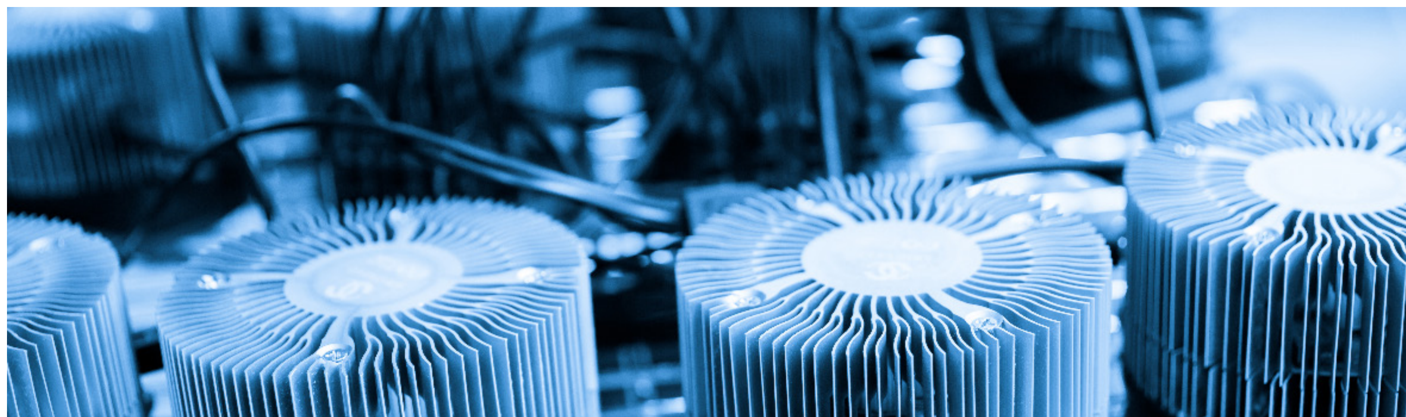
The VAT implications of a CCA-type arrangement have often been considered, particularly in the context of whether or not there can be scope for contributions made to and from parties involved in this type of arrangement to not be supplies provided for consideration.

Applying such an analysis is extremely complex and fact-specific and is only likely to be appropriate where it can be supported that the parties are not carrying out an economic activity as a result of their participation in the CCA and that the parties are working together towards a common aim.

In the event that it is determined that the parties are indeed making supplies of services to each other under a CCA, it must then be established how the value of that supply should be calculated. For UK VAT purposes, the term "consideration" includes both monetary and non-monetary consideration and thus includes scenarios where, instead of payments, reciprocal services are performed, i.e., a barter transaction. Therefore, the value of "consideration" may not be immediately obvious from the application of the TP policy for the CCA, and work may be required to identify and potentially unwind some arrangements in order to determine the correct amount.

Following that, the parties should establish whether there is scope for the services performed (in whole or in part) to fall within a VAT exemption (e.g., for financial services) to mitigate any potential irrecoverable VAT cost arising from receiving services that fall within the scope of VAT. Consideration can then be given to the scope for input tax recovery on any VAT that becomes due. Finally, as with TP documentation, the extent to which the services performed are described in the CCA contractuals could impact the scope for the VAT exemption to apply and/or the VAT recovery position. Thus, consideration of VAT when both creating, and also reviewing, a CCA is critical if the potential impact is to be mitigated.

So, to sum up, when businesses are looking to implement existing TP policies, meet documentary obligations in relation to those policies, or design new policies in their entirety, consideration of the VAT impact is critical to ensure that any unforeseen implications do not arise. Failure to do so can increase the risk of greater indirect tax exposure and impact on any input-VAT recovery.



OECD Work Programme on Tax and the Digitalisation of the Economy

On 31 May 2019, as part of the ongoing work of the G20/OECD Inclusive Framework on Base Erosion and Profit Shifting, the OECD released a **Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy.** Deloitte comments on the release are included here.

The programme sets out the work to develop proposals under two 'pillars':

- Pillar One: Revising **nexus** and **profit allocation rules** to address how taxing rights should be **allocated among countries** and, in particular, to **market countries**
- Pillar Two: A **global anti-base erosion proposal to strengthen countries' ability to tax profits** where income is locally subject to **a low effective rate of tax.**

Deloitte Comments: Implications for the Financial Services Sector

In addition to the overall comments referred to above, this article seeks to consider the potential impact on the financial services sector. The proposals and wide-reaching reforms under consideration could have a significant impact on the financial services sector, particularly for organizations that have access to customers in different jurisdictions under "freedom of establishment" or passporting rules. The comments in the Deloitte release referred to above should equally be considered for financial services businesses, for example, the focus of Pillar One on ensuring sufficient profit is awarded to the "market" jurisdiction, whether the country of users or sales. The analysis below considers, in particular, some of the technological changes to a value chain or distribution mechanism across financial services, however a key point to note is that it could equally impact traditional distribution models across banking, insurance and asset management.

For organizations in banking and capital markets, the nature and the extent of the reforms may impact the taxation of activities undertaken to source funding from international investors or to offer global risk management solutions (through derivatives to hedge various types of financial risks, which are usually booked in a single or select few entities to allow for centralized risk management and natural hedges for the financial institution). While the OECD has specifically highlighted the applicability of new taxing rights to commodities and financial instruments as a potential area for which potential scope limitations may be designed, the availability, extent and nature of any limitations would require careful consideration by governments and businesses alike. The reforms may also impact the commercial operations of offshore banking regimes that have been specifically designed to improve the international competitiveness of the financial services sectors of particular countries.

With regards to the insurance sector, this proposal may impact multinational groups whose business activities include the provision of digital insurance services to customers without a "brick and mortar" presence, e.g. "Insurtech". For example, under this type of operating model, an Insurtech company may distribute insurance products through digital channels from a company based in a one tax jurisdiction to customers based in other tax jurisdictions. Under the proposed nexus rules, this could create a taxable presence in the "market" location, and consideration would then have to be given to how taxing rights should be allocated among the various jurisdictions under the proposed profit allocation rules.

Within the asset management industry, certain structures could be impacted. An example is the retail industry where customers are able to "log-on" to a website or an online platform to manage investments, including from jurisdictions where the asset management business may not have a significant physical presence. As the asset manager would be able to acquire customer data through these activities, there is a risk that these structures could be caught by the proposed nexus rules.

Other design challenges for the financial services sector include the treatment of losses (as a result of risk assumption) and the potential recognition of capital as an allocation key for any new apportionment methods, as typical allocation keys such as employees, tangible assets and sales may be more suited to the non-financial services companies.

Further, technology is forming an increasing part of overall spend within the financial services sector, and the impact of some of the proposed rules may mean heavier weighting is placed on "exploitation" vis-à-vis "development" in an analysis of the value of DEMPE[1] functions performed.

Overview

The OECD participating governments have agreed to work on detailed technical aspects of the proposals in order to help inform the political discussions, with a view to countries reaching political agreement by the end of 2019. Alongside the tax technical work the OECD will undertake economic studies to evaluate the impact of proposed measures.

The program highlights the significance of the technical work that needs to be completed. Key areas will include when a country has the right to tax trading profits and the rules for allocation of trading profits to each country. A particular focus is on ensuring sufficient profit is awarded to the 'market' jurisdiction, whether the country of users or sales. Detailed design considerations will look at the use of a residual profit split approach (either on a global or business line/regional basis) alongside existing transfer pricing rules, or the use of formulae or 'fractional apportionment' by reference to metrics such as sales, employees, assets or users. A newly proposed approach considers a base level of return for distribution activities in market countries. Technical topics to be analyzed include, for example, the implications for losses, cost-plus approaches, and existing withholding tax rules. The global income inclusion rule to allow countries to require a minimum effective level of tax will also be part of the programme of work.
Changes, when agreed, will have implications for and require significant amendments to existing double tax treaties, the OECD's Transfer Pricing Guidelines, rules for the attribution of profits to permanent establishments and also domestic legislation. As such, it is likely to take some time before any new rules can be effectively implemented.

For businesses, the key concern, expressed at the public consultation meeting in March 2019, will be to ensure that profits are taxed only once and that there is effective and timely resolution of disputes between countries. Clear rules and boundaries will help with this, but binding arbitration or other measures to give certainty will also be essential. The work programme makes clear that, given the potentially extensive and disruptive changes being considered, both governments and businesses want simplification where possible. This is particularly important given that the BEPS Inclusive Framework is made up of 129 countries, many of them developing, and the desire for a system and measures that can be administered and adopted on a global basis.

The work programme will require significant resources from governments participating in the OECD Inclusive Framework. The overarching objective though, for businesses and for international growth, is that there remains a consistent global framework that does not hinder cross-border financial services or the efficient functioning of the global financial markets.

1 DEMPE = Development, Enhancement, Maintenance, Protection, Exploitation

Deloitte Member Firm Global Network

Financial Services Transfer Pricing contacts

Asia Pacific (APAC)

Russia

Vladimir Elizarov
Partner
Tel: +7 4957 870 600
velizarov@deloitte.ru

Japan

Sam Gordon
Partner
Tel: +81 362 133 760
samuel.gordon@tohmatsu.co.jp

Ken Takahashi
Partner
Tel: +81 804 183 7314
ken.takahashi@tohmatsu.co.jp

China

Natalie Na Yu
Partner
Tel: +86 1085 207 567
natyu@deloitte.com.cn

Louisa Yan Liu
Director
Tel: +86 21 6141 1769
loliu@deloitte.com.cn

John Leightley
Senior Manager
Tel: +86 21 6141 1248
johnleightley@deloitte.com.cn

Hong Kong

Jonathan Culver
Partner
Tel: +852 2852 6683
joculver@deloitte.com.hk

India

Anis Chakravarty
Partner
Tel: +91 22 6185 4265
anchakravarty@deloitte.com

Singapore

Michael Velten
Partner
Tel: +65 6531 5039
mvelten@deloitte.com

Indonesia

Roy David Kiantiong
Partner
Tel: +62 21 5081 8900
rkiantiong@deloitte.com

Australia

Geoff Gill
Partner
Tel: +61 2 9322 5358
gegill@deloitte.com.au

Stan Hales
Partner
Tel: +61 2 9322 5500
sthales@deloitte.com.au

Europe, the Middle East and Africa (EMEA)

Sweden

David Godin
Partner
Tel: +46 70 080 30 51
dgodin@deloitte.se

Finland

Hanna Viilo
Partner
Tel: +358 207 555 685
Hanna.Viilo@deloitte.fi

Virpi Pasanen
Director
Tel: +358 207 555 813
Virpi.Pasanen@deloitte.fi

Netherlands

Pim Gerritsen van der Hoop
Director
Tel: +31 882 883 880
pgerritsenvanderhoop@deloitte.nl

Rasmus Steiness
Senior Manager
Tel: +31 882 883 264
rsteiness@deloitte.nl

UK

Stephen Weston
Partner
Tel: +44 20 7007 4568
sgweston@deloitte.co.uk

Greg Martin
Partner
Tel: +44 20 7007 6715
gjmartin@deloitte.co.uk

Sebastian Ma'ilei
Partner
Tel: +44 20 7007 1596
smailei@deloitte.co.uk

Giles Hillman
Partner
Tel: +44 20 7007 3750
ghillman@deloitte.co.uk

Denmark

Jesper Skovhus
Partner
Tel: +45 20 74 28 04
jskovhus@deloitte.dk

Luxembourg

Ralf Heussner
Partner
Tel: +352 45145 3313
rheussner@deloitte.lu

Ireland

Gerard Feeney
Director
Tel: +353 1417 2403
gfeeney@deloitte.ie

Germany

Oliver Busch
Partner
Tel: +49 69 75695 6906
obusch@deloitte.de

Jobst Wilmanns
Partner
Tel: +49 697 5695 6243
jwilmanns@deloitte.de

Silke Imig
Director
Tel: +49 69 75695 7266
simig@deloitte.de

Belgium

Mourad Chatar
Director
Tel: +32 2 600 67 34
mchatar@deloitte.com

Italy

Marco Mazzetti
Partner
Tel: +39 064 899 0910
mmazzetti@deloitte.it

Aldo Castoldi
Partner
Tel: +39 028 332 4036
acastoldi@deloitte.it

Portugal

Patricia Maria Matos
Partner
Tel: +351 210 427 534
pamatos@deloitte.pt

South Africa

Billy Joubert
Director
Tel: +27 118 065 352
bjoubert@deloitte.co.za

Spain

Josep Serrano Torres
Partner
Tel: +34 932 304 984
jserranotorres@deloitte.es

Juan Ignacio de Molina
Partner
Tel: +34 932 304 804
jdemolina@deloitte.es

France

Gregoire de Vogue
Partner
Tel: +33 1 40 88 22 20
gdevogue@deloitte.taj.fr

Dubai

Shiv Mahalingham
Partner
Tel: +971 4506 4700
smahalingham@deloitte.com

Switzerland

Salim Damji
Partner
Tel: +41 58 279 6217
sdamji@deloitte.ch

Georgy Galumov
Director
Tel: +41 58 279 8142
gegalumov@deloitte.ch

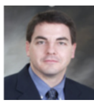
US and Canada

Canada

Muris Dujsic
Partner
Tel: +1 416 601 6006
mdujsic@deloitte.ca

Inna Golodniuk
Senior Manager
Tel: +1 416 601 5934
igolodniuk@deloitte.ca

US



Rob Plunkett
Tax Principal
Tel: +1 212 436 5261
rplunkett@deloitte.com

Matej Cresnik
Tax Principal
Tel: +1 212 436 7760
mcresnik@deloitte.com

Bill Yohana
Tax Managing Director
Tel: +1 212 436 5578
byohana@deloitte.com

Darrin Litsky
Tax Managing Director
Tel: +1 212 436 5760
dlitsky@deloitte.com

Article contributors

Jeremy Brown
Director
UK

Ralf Heussner
Partner
Luxembourg

Peter Johns
Director
UK

Greg Martin
Partner
UK

Priscilla Ratilal
Director
UK

Daniel Stewart
Consultant
UK

Andrew Dalah
Director
UK

Giles Hillman
Partner
UK

Rachel Lim
Tax Professional
Frankfurt

Luka Pillai
Associate Director
UK

Neil Reeve
Partner
UK

Anodri Suchdeve
Senior Manager
Frankfurt

William Dawson
Consultant
UK

Silke Imig
Director
Frankfurt

Sebastian Ma'ilei
Partner
UK

Rob Plunkett
Tax Principal
New York

Rasmus Steiness
Senior Manager
The Netherlands

Stephen Weston
Partner
UK

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