



Freshfields Bruckhaus Deringer



BEPS and state aid: a shifting landscape for IP planning

Competition Law Association

Giles Pratt, Freshfields Bruckhaus Deringer

Meloria Meschi, FTI Consulting

Job van der Pol, Freshfields Bruckhaus Deringer

Mark Bezant, FTI Consulting

Introduction to the Starbucks decision

Meloria Meschi

16 February 2016

The European Commission Starbucks decision



Background

- SM and Dutch Tax Authority (DTA) agreed an advance pricing agreement (APA) on the application of tax legislation for SM
- Under the APA, SM and DTA agreed that SM would use the transactional net margin method (TNMM) for its intra-group transactions
- The APA also agreed that:
 - SM would be treated as a toll manufacturer
 - Tax based only on those profits for which SM “added value”
 - Excluded profits attributable to SM sourcing the coffee beans
- SM calculated the royalties due to ALKI as the “plug” so that SM’s PBT margin matched that of its peers (being 9%-12%) and was therefore at “arm’s length”

The European Commission Starbucks decision (2)

June 2014 Preliminary View

- The APA constitutes state aid, because:
 - SM is not a toll manufacturer
 - DTA allowed SM to make “questionable adjustments” to lower its tax base
 - The ALKI royalties varied significantly each year (not in line with revenue)— a red flag that the APA was not appropriate
- European Commission ruled that further investigation required

October 2015 Decision

- Confirmed decision that the APA constitutes state aid, as, *inter alia*, it gave SM a competitive advantage
- The royalties did not value the IP correctly and were therefore not at arm’s length, because:
 - Variable nature of royalty calculation meant that no method to determine if arm’s length
 - Comparable agreements with coffee roasters suggest no royalty due
 - SM received no business advantage from the use of ALKI’s IP

Status

Ongoing investigations / final decisions

- Starbucks (Netherlands) – Final Decision issued on 21 October 2015; both Starbucks and the Netherlands are appealing;
- Fiat Finance & Trade (Luxembourg) - Final Decision issued on 21 October 2015; both FFT and Luxembourg are appealing;
- Apple (Ireland) – Opening Decision issued on 11 June 2014, both are expected to appeal in case of a negative decision;
- Amazon (Luxembourg) – Opening Decision issued on 7 October 2014;
- McDonalds (Luxembourg) – Opening Decision issued on 3 December 2015;
- Excess profit rulings (Belgian; 35 beneficiaries) – Final Decision issued on 11 January 2016; Belgium expected to appeal.

Commission positions – advantage

Counterfactual

- Counterfactual: all profits should be taxable
- Based on Paint Graphos
- Implication: any exemption, credit, reduction forms a possible selective advantage

Arm's length principle (ALP)

- Form of ALP, derived from TFEU / Forum 187
- Different from OECD ALP?

Commission positions – selectivity

CLFS

- Companies that are part of a (multinational) group are in a CLFS as (local) stand-alone companies
- any advantage that is available to members of multinational groups but not to stand alone companies, would be selective.
- This includes, for example,
 - alleged advantages from incorrect transfer pricing, and
 - advantages based on international mismatches of tax systems (as stand-alone companies can benefit from neither)
- Impact recent GC case law on selectivity

Trends – IP specific

Commission focus areas

- Tax rulings containing “artificial and complex methods of establishing taxable profits” or “economically unjustified assumptions” which are “not reflecting the economic reality” will be closely scrutinised by the Commission
- Residence mismatches
- Notional deductions
- Hybrid instrument mismatches

Trends – IP specific

Source state vs. market state

“These initiatives are only the start of the establishment of a fairer tax system in Europe, on the basis of which profits are taxed where value is created.”

(Joint editorial Commissioner Moscovici and Commissioner Vestager, *This is the year for Europe to put its tax house in order*, THE GUARDIAN (17 Jan. 2015))

“... it is an obvious right ... for European tax authorities to tax money that is made in the member states.”

(Commissioner Vestager, 1 February 2016)

BEPS Actions 8-10

Objectives

Aligning Transfer Pricing ('TP') outcomes with value creation by:

- Development of “Rules to prevent BEPS by transferring risks among, or allocating excessive capital to, group members.” (contract versus conduct); and
- Development of “Rules to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties.” (recharacterisation).

BEPS 8-10 – content



Action Plan on Base Erosion and Profit Shifting

- Action 8: Intangibles
- Action 9: Risks and capital
- Action 10: Other high-risk transactions

Aligning Transfer Pricing Outcomes with Value Creation

Guidance on Applying the Arm's Length Principle
Chapter I

Cost Contribution Arrangements
Chapter VIII

Transactional Profit Split Method

Intangibles
Chapter VI

Low Value-adding Intra-group Services
Chapter VII

Commodity Transactions
Chapter II

Remuneration of IP functions

- Legal ownership of IP alone does not determine entitlement to returns from IP exploitation;
- Important value-creating functions (R&D, enhancement, maintenance, protection and exploitation) result in appropriate remuneration;
- Risk assumption only recognized in case of risk control and having the financial capacity to assume the risks;
- Funding without any of the important functions and:
 - Exercising control over the financial risk -> risk-adjusted return; or
 - without exercising control over the financial risk - > no more than a risk-free return.

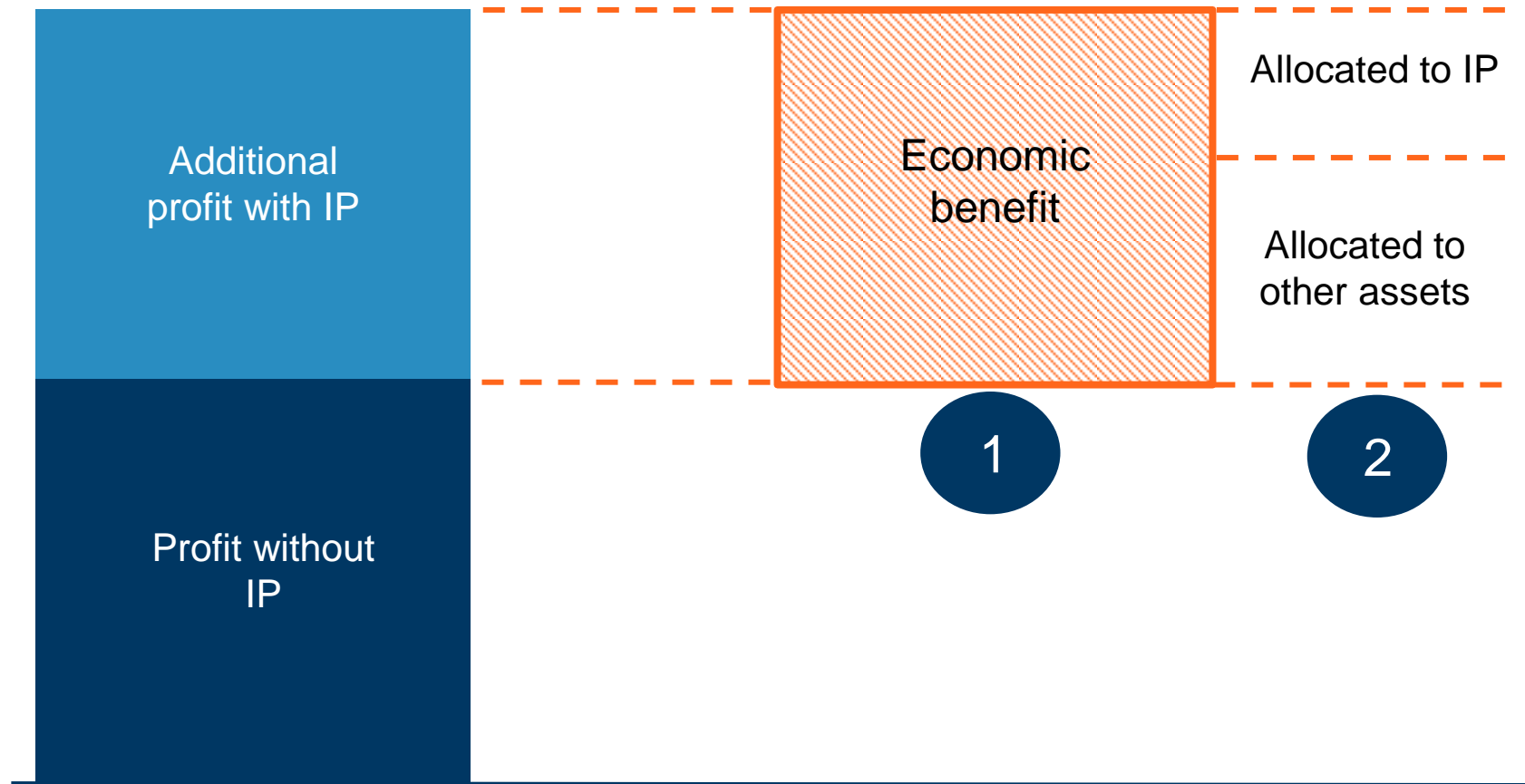
IP Valuation and Transfer Pricing

Mark Bezant

16 February 2016

What is IP value?

Illustration of the IP valuation framework





IP valuation methods

Economic benefits approach

Estimate incremental value generated by use of the IP and how this value should be split between the IP and other assets directly

Comparables

Use transactions (either sales or, more commonly, licences) to benchmark the share of incremental value attributed to the IP

Incremental value can be directly estimated in some circumstances...

Example estimate of incremental value

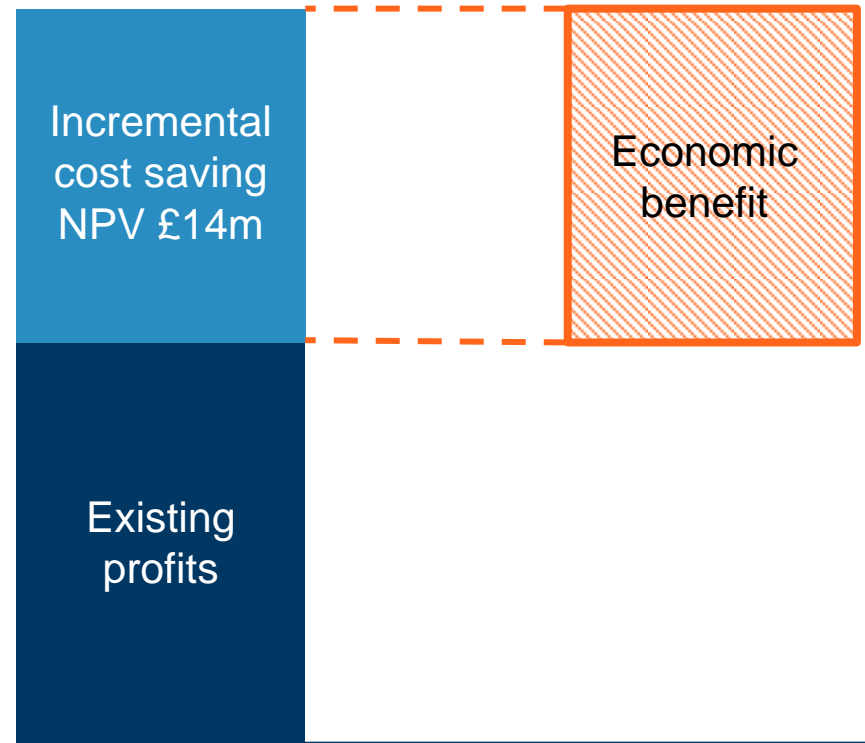
- Technology to reduce costs by 5% each year
- Patent expires in 2018
- 2015 costs of GBP 100 million
- Total costs are expected to grow at 3% per year
- Discount rate of 8%

	2016	2017	2018
Total costs - without licence	£103m	£106m	£109m
Total costs - with licence	£98m	£101m	£104m
Incremental income	£5m	£5m	£5m
Discount factor	0.93	0.86	0.79
Present value	£5m	£5m	£4m

Value £14m



Illustration





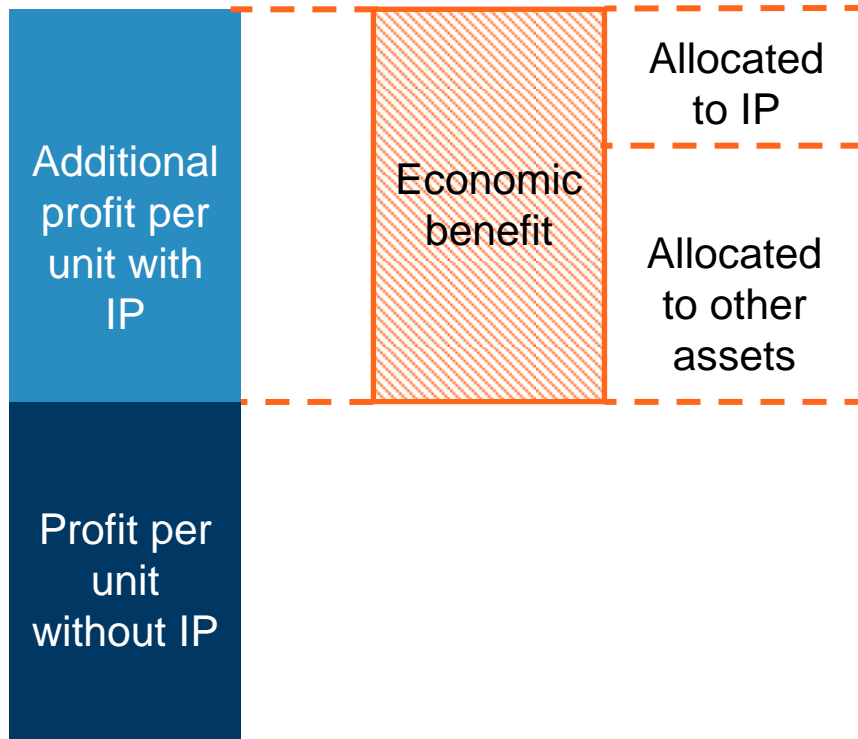
...but incremental value is often uncertain and difficult to estimate

Often more difficult to calculate the incremental benefits:

- The IP asset may be used in combination with other assets and may be difficult to isolate the incremental benefit from the IP asset
- The IP asset may be new and may be difficult to estimate the expected benefits from using the IP
- It may be difficult to estimate the economic life of the IP asset
 - legal protections
 - market changes
- It may be difficult to forecast the incremental income into the future

Allocation of economic benefits between the IP and other assets

Illustration



Issues

- Potentially the most difficult step in estimating IP value when using the economic benefits approach
- Rule of thumb is to allocate 25% to 33% of incremental value to the IP

Allocation of economic benefits between the IP and other assets (2)

The 25% rule

- The “25% rule” where 25% of operating profit is allocated to the IP has been criticised in recent years in US patent cases
- For example, in *Uniloc v Microsoft* (2011), the US Appeals Court said:
“This court now holds as a matter of Federal Circuit law that the 25 percent rule of thumb is a fundamentally flawed tool for determining a baseline royalty rate in a hypothetical negotiation. Evidence relying on the 25 percent rule of thumb is thus inadmissible under Daubert and the Federal Rules of Evidence, because it fails to tie a reasonable royalty base to the facts of the case at issue.”
- However, versions of the 25% rule are still advanced by UK IPO and HMRC

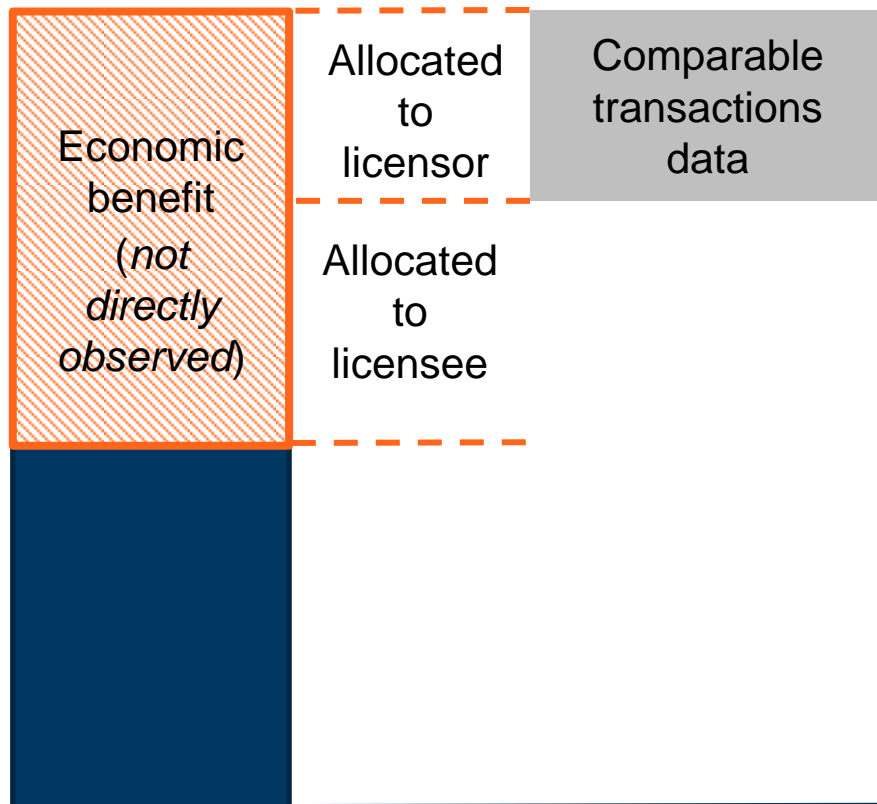
Allocation of economic benefits between the IP and other assets (3)

The sharing rule from bilateral negotiations

- Recent empirical research shows that profit sharing in bilateral negotiations can vary significantly:
 - Bonnet (2015) found that in contract negotiations between manufacturers and retailers, the retailer received between 20% and 100% of the economic benefit
 - Grennan (2013) found that in contract negotiations between hospitals and their suppliers, the supplier received between 8% to 71% of the economic benefit
 - Crawford and Yurukoglu (2012) found that in contract negotiations between television channels and distributors, the distributor received between 17% and 77% of the economic benefit

The comparables approach relies upon 'real-world' data from actual transactions

Illustration of the comparables approach



Method/Concerns with this approach

- Assess comparability based on economically relevant characteristics
- Comparables data might contain only summary royalty terms
- Difficult to find truly comparable data

The comparables approach can be problematic for transfer pricing where characteristics of transacting parties can differ substantially from typical parties to real-world transactions

As a result of these challenges, there is normally no single 'correct' value

Illustration



Issues

- Important to establish the bargaining range in transfer pricing context
 - what is the minimum price that the licensor or seller of the IP will accept?
 - what is the minimum return that the licensee or seller would require for the functions and risks that they bear?
- Important to check consistency between transactions

BEPS is a key initiative to reduce manipulation of transfer pricing using IP

BEPS Actions 8-10

For “hard-to-value” intangible assets for which valuation is highly uncertain, tax administrations can consider ex post outcomes as evidence about the appropriateness of ex ante pricing arrangements

Benefits from corporate synergies are allocated to group members that contributed to those synergies

Legal ownership alone does not necessarily generate a right to any of the return from the IP asset

Specific reporting requirements for low value-adding intra-group services

Company responses

Protect themselves against future tax authority ‘look-back’ by ensuring that ex ante pricing arrangements are consistent with forecasted outcomes

Identify corporate synergies and those group companies that contribute to them

Consider an allocation of profit between the licensor and licensee that is not based on legal ownership of the asset

Comply with reporting requirements

Companies are frustrated with the increased workload from BEPS. We see a trend of companies seeking to simplify their tax structures: to pay tax only once rather than lower their tax rate with complex IP structures. Some companies have expressed a wish for a European tax authority

Questions & answers



Thank you

This material is provided by the international law firm Freshfields Bruckhaus Deringer LLP (a limited liability partnership organised under the law of England and Wales authorised and regulated by the Solicitors Regulation Authority) (the UK LLP) and the offices and associated entities of the UK LLP practising under the Freshfields Bruckhaus Deringer name in a number of jurisdictions, and Freshfields Bruckhaus Deringer US LLP, together referred to in the material as 'Freshfields'. For regulatory information please refer to www.freshfields.com/support/legalnotice.

The UK LLP has offices or associated entities in Austria, Bahrain, Belgium, China, England, France, Germany, Hong Kong, Italy, Japan, the Netherlands, Russia, Singapore, Spain, the United Arab Emirates and Vietnam. Freshfields Bruckhaus Deringer US LLP has offices in New York City and Washington DC.

This material is for general information only and is not intended to provide legal advice.

© Freshfields Bruckhaus Deringer LLP 2016