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BEPS and State Aid: A Shifting Landscape in IP Planning

Date: Tuesday 16 February 2016

Venue: Freshfields Bruckhaus Deringer LLP

Speakers: Meloria Meschi (FTI Consulting), Job van der Pol (Freshfields), Mark Bezant (FTI Consulting)

Chair: Giles Pratt (Freshfields)

SUMMARY NOTE

1. The topic of the meeting was to discuss trends in IP and tax planning in light of:
 - a. the actions recently identified by the Organisation for Economic Co-operation and Development (**OECD**) to tackle so-called 'base erosion and profit shifting' (**BEPS**); and
 - b. the decisions of the European Commission (the **Commission**) in the recent state aid cases against the Netherlands and Luxembourg relating to their tax rulings in favour of Starbucks and Fiat, respectively.
2. Details of the OECD's BEPS package can be found [here](#).
3. The Commission's press release relating to the *Starbucks* and *Fiat* cases can be found [here](#).

Giles Pratt: Introduction

4. Giles Pratt opened the meeting with an overview of the shifting public and political mood over the past five years.
5. Regulators want multinational companies pay what they perceive to be a 'fair share' of tax. The OECD's BEPS report contains recommendations aimed at ensuring that multinationals are taxed in the jurisdictions in which their actual business activities take place and where value is created.
6. One of the areas called out in the report involves 'patent box' or 'IP box' schemes. The OECD is proposing a new 'nexus' approach. This will tie patent box benefits to R&D expenditure actually made by the UK entity (not by other companies in its corporate group).
7. Regulators are also starting to use competition law to challenge tax structures, as highlighted in the *Starbucks* and *Fiat* decisions.

Meloria Meschi: Introduction to the *Starbucks* decision

8. Meloria gave an overview of the recent *Starbucks* decision.
9. The Commission's decision relates to an advance pricing agreement (**APA**) between Starbucks and the Dutch tax authority. The APA used a net margin method for valuing its intra-group transactions, and treated the Dutch entity like a toll manufacturer.
10. The Commission found that the APA amounted to state aid for three reasons. In the Commission's view: (i) the Dutch Starbucks entity was not a toll manufacturer; (ii) the APA allowed 'questionable adjustments' to royalties; and (iii) the royalties paid to the UK subsidiary varied materially each year.
11. According to the Commission, Starbucks had not valued its IP correctly for three reasons:
 - a. the royalty payable varied dramatically year-on-year;
 - b. comparable coffee roasting agreements did not entail any royalty at all; and
 - c. the Dutch licensee did not obtain any business advantage from using the licensed IP.

These factors meant that the Commission's view was that the licence should not have attracted a royalty at all.

Job van der Pol: BEPS and state aid

12. Job van der Pol then discussed how the *Starbucks* decision is symptomatic of an increasing use of state aid as a mechanism to challenge national tax rulings. The current cases are likely only to be the tip of the iceberg.
13. Whether or not an agreement with a national tax authority constitutes state aid is assessed by reference to several elements, the key ones in these cases being (i) advantage; and (ii) selectivity. The Commission can sometimes conflate these two concepts, but has to prove both.
14. Advantage is assessed by reference to a benchmark – i.e. the 'normal' tax treatment, absent the tax authority's ruling. The Commission determines advantage by applying the 'arm's length principle'. Originally, the Commission relied on the arm's length principle as set out in the OECD's non-binding model tax convention, but increasingly appears to apply a form of arm's length principle allegedly based on the Treaty on the Function of the European Union.
15. Selectivity requires an assessment of the measure against other undertakings in a comparable legal and factual situation (**CLFS**). The Commission takes a broad approach to CLFS – it treats multinationals the same as domestic companies. But multinationals have a range of

concerns (particularly relating to avoiding double taxation) that are not relevant to companies with only one domestic presence.

16. The Commission is also critical of notional deductions which take place where there is no corresponding payment or receipt.
17. The reality is that tax rulings are always an interpretation of transfer pricing guidelines, and so will often serve as a 'red flag' to the Commission.

Mark Bezzant: IP valuation and transfer pricing

18. Mark then spoke about how IP valuation methodologies can provide a wide range of values, depending on the nature of the IP and the specific applications thereof.

19. There are broadly two methods of valuing IP:

- a. Economic benefits: This works by estimating the incremental value generated by the use of the IP and how this value should be split between the IP and other assets which contribute to generating value.
- b. Comparables: These may be difficult unless there is an existing transaction (sale or licence) for an indication of value.

20. In some circumstances incremental value can be directly estimated. In others it's more difficult. In the pharmaceutical sector, for example, patents while central to value may not be the only or major contributor as brands, marketing workforce, clinical trials data, and manufacturing know-how and distribution may all play a role. This means it's important to document what you did to value the product.

21. Historically, companies allocated 25 – 35% of the incremental value to the IP. However, courts and regulators are becoming more reluctant to accept over-simplistic approaches.

22. You need to be careful to use sensible comparables. Not all buyers and sellers have a single tipping point – bargaining ranges can be very large, leading to a big range of legitimate outcomes. This is where the comparables approach may create transfer pricing challenges, as the characteristics of transacting parties can differ substantially.

23. The OECD's BEPS programme is a key initiative to reduce manipulation of transfer pricing using IP, but there's not a lot to study. Ultimately, it's just people wanting more robust justifications for transfer pricing. In reality, it seems this will require you to show that you are not doing something so alien that you wouldn't see it anywhere. This is where the ruling in the *Starbucks* case fell down.

24. It's still early days for companies, although they are seeing an increased workload as a result of BEPS. Generally, clients don't mind tax rules changing – they just don't want to pay tax twice.