European Union Hot Topics

Mark O'Sullivan, Matheson

Paul Rutherford, DLA Piper

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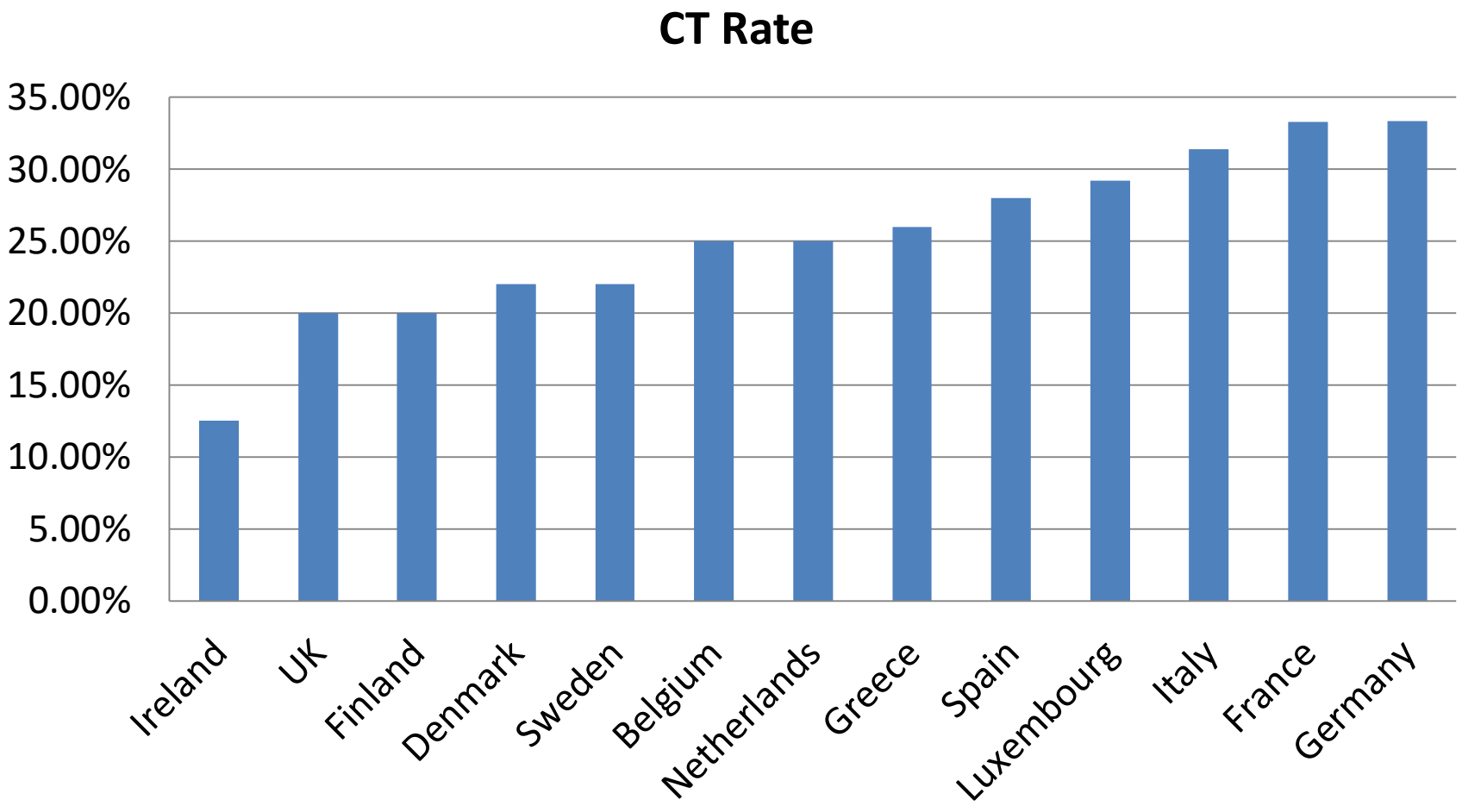
Summary

- Tax rate competition
- IP Box regimes
- EU unilateral reactions to BEPS
- Tax Rulings in the EU
- EU Parent/Subsidiary Directive
- EU State Aid

EU Company Tax Rate Competition



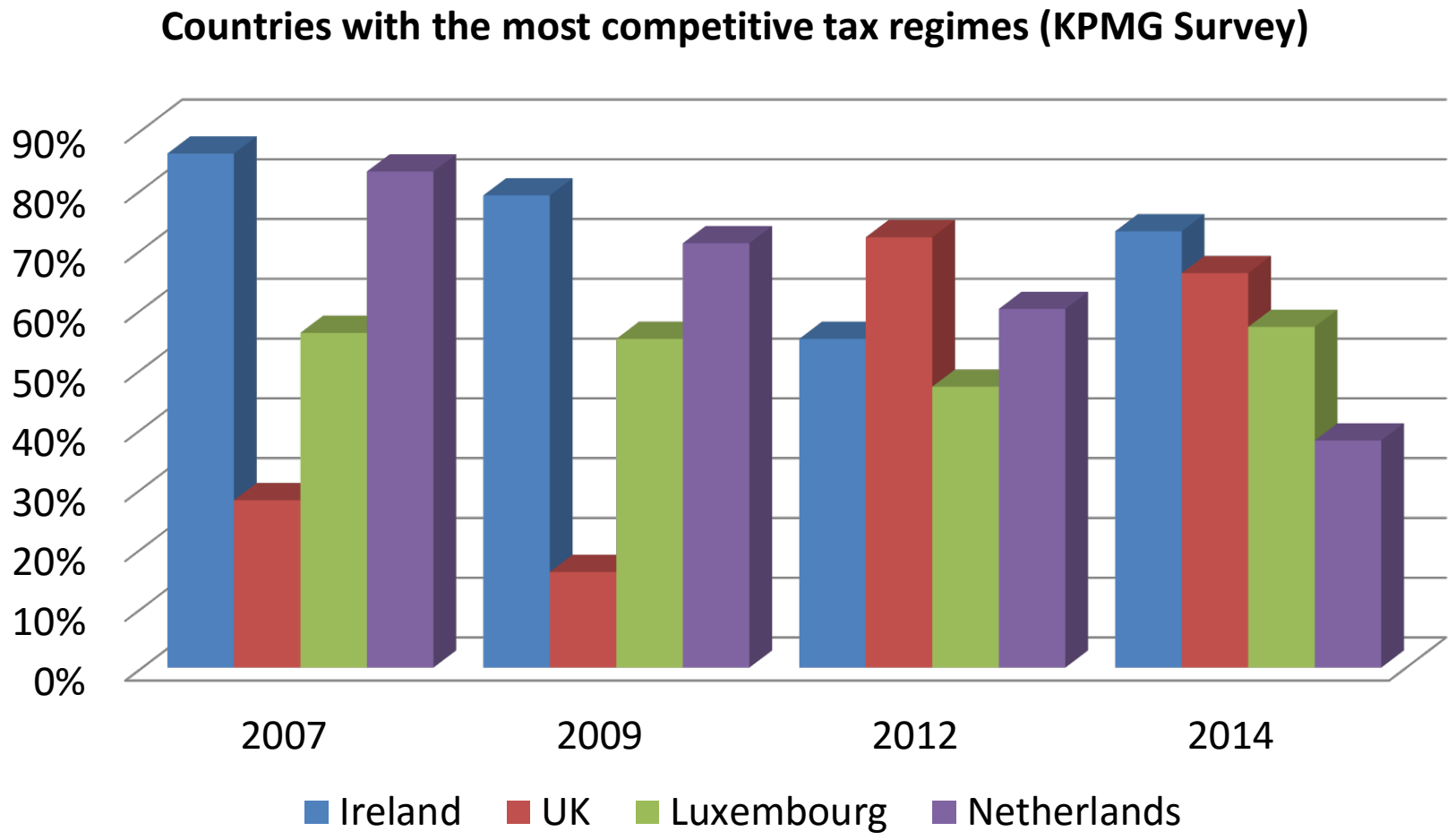
Tax Rate Competition

Is rate competition alone sufficient?

- participation exemption on dividends and gains
- interest deductibility rules
- CFC rules
- taxation of overseas branch profits
- preferred taxation regimes (eg IP boxes)
- EU membership and treaty networks
- non-tax factors (eg language, labour laws, regulatory environment)

Ireland and UK experience vs The Netherlands and Luxembourg?

Tax Rate Competition



Tax Rate Competition

EC Attitude?

- Direct taxes a matter solely for Member States (subject to certain "fundamental freedoms") (cf value added tax)
- EU Annual Growth Survey - benefits from lower corporate tax rates with broader tax base
  - less incentive for avoidance
  - more efficient mechanism for allocating mobile capital
  - naturally reduces benefit of debt finance over equity
  - corporate tax revenues generally remained stable across EU
- Long-term desire to consolidate tax base – but not rates
- But some countries (eg France, Germany) want an EU corporate tax rate floor

EU "IP Box" Regimes

What are they?

- Preferential tax regimes applicable to income from certain types of IP asset

Where are they?

- Existing - Belgium, France, Hungary, Italy, Luxembourg, The Netherlands, Spain, UK
- Pending - Ireland

How successful have they been?

- Benelux countries (circa 2008)
  - increase in patent registrations after patent box regimes introduced
  - increased tax revenues have not fully offset cost of lower tax rates
  - marginally higher levels of R&D compared to non-IP box countries

EU "IP Box" Regimes

How successful have they been (cont'd)?

- UK (April 2013)
  - modest growth (2.1%) in 2014 patent registrations (cf general decline since 2005)
  - limited hard data on financial impact – some evidence to suggest less of a "shift" in activity to other countries (eg Luxembourg, The Netherlands)

EU "IP Box" Regimes

Criterion	Luxembourg	The Netherlands	United Kingdom	Ireland
Effective tax rate	5.7%	5%	10% (from April 2017)	6.25%
Qualifying income	Arm's length net income directly connected with qualifying IP assets. Capital gains included.	Arm's length net income directly connected with qualifying IP assets. Capital gains included.	Net profits from exploiting qualifying IP rights (including products and services incorporating qualifying rights). Capital gains included.	Arm's length net income derived from qualifying expenditure in the EU by Irish corporate taxpayer. Capital gains excluded.
Qualifying asset classes	Patents, patent applications, trademarks, designs, models, software copyright, service marks, internet domain names	Patents, IP subject to an R&D declaration, plant breeder rights	UK, EU and certain EEA territory patents and supplementary protections, plant breeders' rights, exclusive licence of qualifying rights	Software copyright, qualifying patents and supplementary protections, plant breeders' rights
Excluded asset classes	Copyright in literary or artistic works or plans, secret formulae and processes	Brands, logos and similar assets	Marketing assets (eg trade marks, logos, customer lists)	Marketing assets (eg trade marks, logos, customer lists)

EU "IP Box" Regimes

Criterion	Luxembourg	The Netherlands	United Kingdom	Ireland
R&D activity requirement	Yes, but not necessarily in Luxembourg or by taxpayer company	Yes, but not necessarily in The Netherlands or by the taxpayer company	No, but reduction in patent box deduction if there is a shortfall in R&D expenditure in the previous four years	Yes – qualifying profits determined by the proportion that the Irish company's R&D bears to the total R&D costs on the asset; related party R&D largely excluded
Does acquired IP qualify?	Yes, but subject to restrictions where seller is connected with acquirer	No, unless the acquirer needs to further develop the IP	No, unless the acquirer must make a significant contribution to the development of the IP (or any product or process incorporating the IP)	No, unless the acquirer conducts significant further R&D in relation to the IP
Effective date	1 January 2008	1 January 2007 (substantial amendments on 1 January 2010)	1 April 2013 (full benefit from 1 April 2017)	1 January 2016?

EU "IP Box" Regimes

International challenges

- Germany (mid-2013)
  - the (UK) patent box gives unfair preferential tax treatment to IP and encourages inappropriate tax avoidance

- The United Kingdom (mid-2013)
  - the UK patent box encourages *bona fide* innovation and is compliant with EU code of conduct on business taxation

- EU (Oct 2013 – March 2014)
  - UK patent box does amount to harmful tax competition
  - investigation into EU IP box regimes generally – State Aid concerns

- Anglo-German accord (November 2014) – "modified nexus" approach ("MNA")

EU "IP Box" Regimes

International challenges (cont'd)

- EU Code of Conduct Group on Business Taxation, OECD and EC all endorse MNA (February 2015)
  - EC ends investigation into EU IP box regimes
  - all *existing* EU IP box regimes must be amended to comply with modified nexus approach
  - BEPS Action 5

- UK and Luxembourg announced amendments to domestic regimes (post BEPS Action 5 report)

- Italy and Ireland – already compliant?

EU "IP Box" Regimes

Modified nexus approach

- Existing regimes closed to new entrants from July 2016 and grandfathered until July 2021
- Substantial activity requirement
  - taxpayers can only benefit from preferential IP regimes to the extent that they incur R&D expenditure that produces IP income

$$\frac{Qualifying\ expenditure\ on\ developing\ IP\ asset}{Total\ expenditure\ on\ developing\ IP\ asset} \times Income\ from\ IP\ asset = Income\ receiving\ tax\ benefits$$

  - direct R&D and R&D outsourced to unconnected parties qualifies in full
  - maximum 30% uplift for related party outsourcing and acquisition costs

EU "IP Box" Regimes (cont'd)

Modified nexus approach (cont'd)

- Tracking and tracing
  - local countries to develop own rules
  - expenditure should be "directly linked" to an IP asset
    - speculative R&D expenditure included?
    - finance costs, building costs, acquisition costs excluded
  - Income should be derived from the IP asset
    - royalties, capital gains, embedded IP income from sale of products and use of processes included
    - marketing intangibles, routine returns excluded

EU "IP Box" Regimes (cont'd)

Attractiveness for US MNCs?

- Not all regimes (eg UK) recognise US-registered patents
- Notoriously difficult to obtain an EU patent for computer software
- Post-June 2016 - attractiveness curtailed by "in country" R&D requirement?
- Possible US patent box?

EU – Dealing with BEPS

EU Action Plan

- Ensure harmonised EU approach to BEPS implementation
  - legally binding directives
  - harmonised definitions of certain concepts – eg debt, equity, opaque and transparent for anti-hybrid measures
- Monitor implementation of new or amended IP regimes
- Long-term goal – common consolidated tax base to be re-launched in 2016?

Existing measures

- Changes to the EU Parent / Subsidiary Directive introducing a GAAR and addressing hybrid mismatches
- New EU Directive on Automatic Exchange of Information regarding Tax Rulings (effective 1 January 2017)
- State Aid investigations relating to past rulings

Dealing with BEPS – UK Interest

Current UK rules

- Restriction to arm's length amount of interest
- Worldwide debt cap

UK response to BEPS Action 4

- Consultation published on October 22
- UK Government recognises significant impact
- Any changes unlikely before April 2017
- Considering OECD fixed ratio rule (10-30% EBITDA)
  - should it apply at entity or group level?
  - should it exclude *de minimis (eg £1m annual interest)*, SMEs, public benefit projects, carry-forward?
- Special rules for banking and insurance sectors?

Dealing with BEPS – UK DPT

Key Features

- 1 April 2015 commencement
- New tax separate from "ordinary" UK corporation tax
- 25% rate (compared with 20% UK corporation tax rate)
- Not self-assessed – HMRC charging notice required
- SMEs excluded
- No clearance mechanism (but possible APA?)
- Query whether covered by UK tax treaties or compatible with EU law
- UK “jumped the gun” on BEPSAction Item 7 (PE) and transfer pricing items?

Scope of the DPT

- Concerned with artificial diversion of profits from the UK (eroding other countries’ tax bases is apparently acceptable)
- Two charging cases:
  - Avoidance of a UK permanent establishment
  - Tax mismatch involving entities or transactions lacking economic substance

Dealing with BEPS – UK DPT

Avoidance of UK PE

- Non-UK entity making sales direct to UK customers
- Connected person (avoided PE) carries on significant UK activity relating to sales (ie £10m+ annual sales)
- Reasonable to assume that arrangements designed to avoid a UK PE?
- Tax avoidance or tax mismatch condition is met
  - Tax avoidance condition - main purpose of arrangements is to avoid UK corporation tax
  - Mismatch condition - connected person's tax < 80% of non-UK company tax (ignoring loss relief) and insufficient economic substance in arrangements

Charge

- DPTcharge generally levied by reference to profits (determined on ordinary TPprinciples) of a hypothetical permanent establishment

Dealing with BEPS – UK DPT

Tax mismatch – insufficient economic substance

- UK company (or PE) enters into transaction or series of transactions with a connected party
- Increase in tax for connected party is less than 80% of tax reduction for UK company
- Insufficient economic substance in arrangements
- Reasonable to assume that arrangements designed to achieve tax reduction

Charge

- DPT charge by reference to increase in profits when correct transfer pricing applied
- Possible re-characterisation – if (but for the tax mismatch) the arrangements would have been structured differently, charge DPT on increased profit arising under that alternative
- Possible APAdefence?
- Correct transfer pricing (or voluntary adjustment) results in **no DPT charge** unless arrangements re-characterised

Dealing with BEPS – UK DPT

Key risk areas

- UK sales and marketing support arrangements where UK entity conducts most of the customer negotiations
- Commissionaire arrangements
- IP licensed to the UK from a low-tax territory where the UK previously owned the IP (or was involved in its creation)
- Equipment leasing to the UK from a low-tax territory

Alternatives and issues?

- Buy-sell distributor (even limited risk)?
- Ensure arm's length transfer pricing?
- Seek ruling or APA from UK tax authority?
- Accounting provision if possible impact on ETR?

Reaction to BEPS

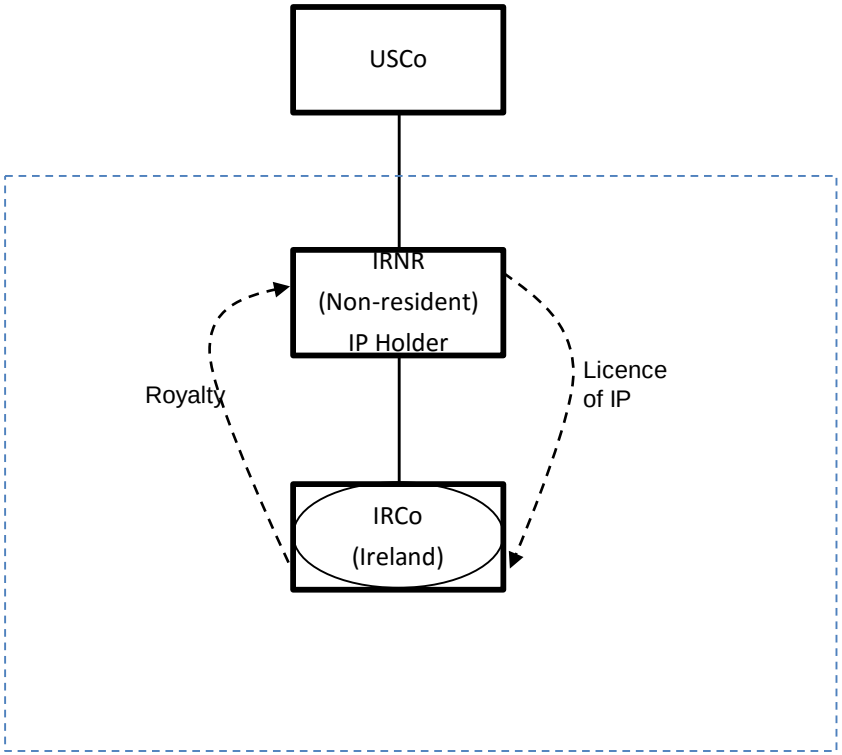
- New interest deductibility rules linked to proportion of EBITA
- Austrian interest deduction rules

Reaction to BEPS - Ireland

- Changes to residence rules to appease OECD partners
  - Phasing out of double-Irish structure
  - Follows move to eliminate nowhere resident companies
- Introduced first “OECD compliant” patent box
  - Modified nexus approach fully adopted
  - Note quite “best in class” patent box

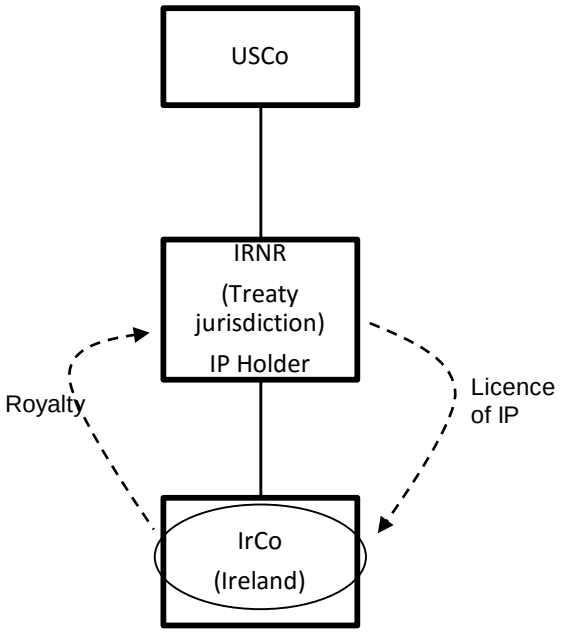
‘DOUBLE/IRISH’ & NEW RULES

- Under the typical structure, IRNR licences IP rights to IRCo which is an Irish incorporated, Irish tax resident operating company
- IRCo utilises the rights granted under the licence for the purposes of its trade in Ireland
- In return for the licence, IRCo pays an ongoing royalty to IRNR with the remaining income subject to Irish corporation tax at the level of IRCo
- “Stateless” company changes – effective 1 January 2015
- 2015 rules – subject to grandfathering, no longer possible to be tax resident outside Ireland, except where the company is resident in a tax treaty jurisdiction
- What do these rules mean in practice?
  - Companies incorporated prior to 1 January 2015 grandfathered until 1 January 2021; and
  - Companies formed on 1 January 2015 or later impacted from 1 January 2015



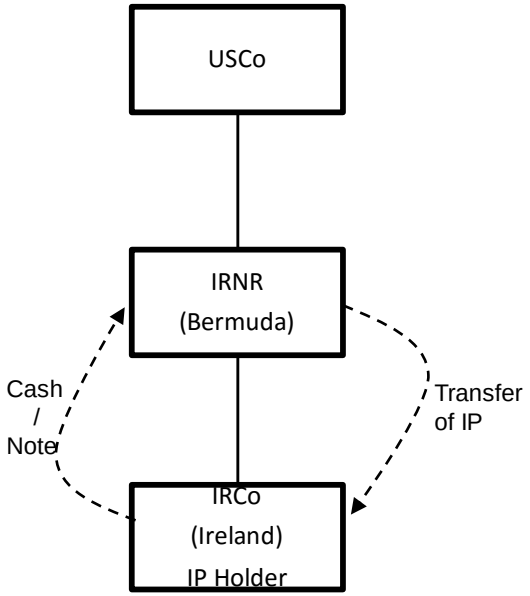
STRUCTURING ALTERNATIVES

- Under this alternative, the management and control of IRNR would be moved from existing offshore location to a treaty jurisdiction with a favorable regime
- Certain treaty jurisdictions do not currently tax income of non-domiciled, but resident companies unless that income is remitted to that jurisdiction
- What is management and control?
- Timing considerations – valuation issues?



STRUCTURING ALTERNATIVES

- BEPS considerations
- Focus of FHTP on realigning profits with substance
- Aggressive positions being taken against nowhere income structures
- Is onshoring the solution?
- IRNR transfers its IP rights to IRCo in exchange for cash or a note
- IRCoutilises the acquired IP rights for the purposes of its trade in Ireland and claims amortisation relief on the acquisition cost of the IP
- Capital cost deductible in line with the amortisation in IrCo's accounts - deduction also available for interest paid by IRCo (if IP acquisition debt financed)
- Deductions previously limited to 80% of trading income from exploitation and management of acquired IP but this restriction will not apply for accounting periods commencing on or after 1 January 2015 – tax rate of between 0% and 12.5% possible
- Applies to self developed or acquired IP
- Interest deduction may also be available
- No clawback where IP is held for 5 years
- Unutilised relief may be carried forward indefinitely



Sharing of Tax Rulings

- On 18 March 2015 the European Commission presented a transparency package to boost tax transparency within the European Union.
- Adopted some of the BEPS proposals
- Key element is the proposal to introduce mandatory automatic exchange of information on advance cross-border rulings and advance pricing arrangements.
  - Automatic exchange should include a defined set of basic information and needs to be sent to *all* Member States as well as to the European Commission.
  - Applies to rulings and pricing arrangements issued after the proposed amendment is adopted.
  - Rulings and pricing arrangements issued less than ten years ago that are still in force to be exchanged before 31 December 2016.
  - Definition of rulings very broad ("*any agreement, communication, or instrument with similar effects*").
  - Effective from 1 January 2016.

EU– Parent-Subsidiary Directive

- De minimis general anti-avoidance rule (GAAR) adopted on 9 December 2014:

"Member States shall not grant the benefits of this Directive to an arrangement or a series of arrangements that, having been put into place for ***the main purpose or one of the main purposes*** *of obtaining a tax advantage which defeats the object or purpose of this Directive, are not genuine having regard to all relevant facts and circumstances. An arrangement may comprise more than one step or part."*

  - Subjective and objective elements
  - No clear guidance on the terms used in the GAAR

- Implemented by member states before 1 January 2016

EU STATE AID

- Follow-up on ruling practices:
  - 1999-2003: investigations into financial services & margins used (harmful tax competition)
- Since June 2013 the EU Commission has investigated the tax ruling practices of seven Member States. The EU Commission requested:
  - an overview of tax rulings provided by six Member states: Cyprus, Ireland, Luxembourg, Malta, the Netherlands and the UK;
  - information from Belgium including on certain specific tax rulings.
- The EU Commission also requested information about IP regimes from ten Member States: Belgium, Cyprus, France, Hungary, Luxembourg, Malta, the Netherlands, Portugal, Spain and the UK.
- On 17 December 2014, the EU Commission enlarged the enquiry into the tax ruling practice under EU state aid rules to cover all Member States. Member States to provide information about their tax ruling practice, in particular to confirm whether they provide tax rulings, and, if they do, to request a list of all companies that have received a tax ruling from 2010 to 2013.
- On 5 May 2015 Margrethe Vestager, EU competition commissioner, announced that the EU Commission would delay its decisions in the Amazon, Apple, Fiat and Starbuck cases
- Fiat and Starbucks decisions handed down in October 2015, Apple and Amazon expected later this month

STATE AID SCRUNITY

All Member States	• Ruling practice, all EU Member States! Gibraltar; Luxembourg; Luxleaks
Belgium	• In-depthinvestigation into Belgian excess profit ruling system
Ireland	• Apple, formal investigation and decision pending
Luxembourg	• Fiat Finance & Trade, final decision found against taxpayer • Amazon, formal investigation and decision pending • IP regime/ruling practice, information injunction • McDonald's? (statement of Vestager on 5 May 2015)
Netherlands	• Starbucks, final decision against taxpayer
Spain	• Both Banco Santander SA and the European Commission filed challenges in a series of litigation rooted in the EC's believe that a Spanish tax regime that allows companies to deduct shareholdings in foreign markets constitutes state aid

STATE AID - FRAMEWORK

- Ensuring that the competition within the EU is not distorted
- Cumulative requirements for state aid (art 107 (1) TFEU):
  - Confer a (financial) advantage to the beneficiary
  - Granted by a Member State or through State resources in any form whatsoever
  - Distorts or threatens to distort competition
  - Selectivity: favouring certain undertakings or the production of certain good
  - Not justified by the nature and the logic of the tax system
- Selectivity most important: is there a favor of certain undertakings in a state and is there an exception to the application of the tax system:

STATE AID AND RULINGS

- The Commission is not questioning the use of tax rulings (ATR) as such:

  "Tax rulings as such are <u>not problematic</u>: they are comfort letters by tax authorities giving a specific company clarity on how its corporate tax will be calculated or on the use of special tax provisions."

- Advance administrative rulings may involve selectivity in particular where:
  - The tax authorities have discretion in granting administrative rulings;
  - The rulings are not available to undertakings in a similar legal and factual situation;
  - The administration appears to apply a more "favourable" discretionary tax treatment compared with other taxpayers in a similar factual and legal situation; and
  - The ruling has been issued in contradiction to the applicable tax provisions and has resulted in a lower amount of tax.

EU STATE AID – OBSERVATIONS

- Rulings covered attribution of profits to Irish branches of two non-Irish companies for two separate periods
- Commission focused primarily on the "selectivity" of the apparent advantage in its Decision
- Commission centred in on whether the transfer pricing "depart[ed] from the arrangement or remuneration that a prudent independent operator acting under normal market conditions would have accepted"
- Commission concluded that rulings did not comply with the arm's length principle
- Argued that the agreed pricing arose from a "negotiation rather than a pricing methodology"
- The fact that no transfer pricing report was included in documents provided by the Irish authorities was deemed important
- Highlighted inconsistencies in pricing approach of the two different branches
- Duration of ruling applied for 15 years without revision which was considered to not be an arm's length form of APA
- Revisionist examination of costs which did not apparently increase in line with profits (in years following the ruling)

EU STATE AID – APPLE CASE

- Commission now appears to be an expert on transfer pricing and has opened up the principle of State Aid to deal with what it perceives to be State-sponsored transfer pricing arrangements which are not in accordance with the arm's length principle
- This is a new departure and the EU Commission is effectively acting like an auxiliary tax authority
- Ireland did not have formal transfer pricing rules in place at the time the rulings were granted
- Commission selectively referred to a cross-section of countries with formal APA rules and equated term of arrangements to something that was not arm's length
- Commission reached certain conclusions without fully supporting or articulating their argument, eg, the assertion that a particular pricing was clearly linked to job creation is not elaborated upon clearly in the decision
- While not altogether common, it was open to other taxpayers to seek similar confirmations as to pricing at the time

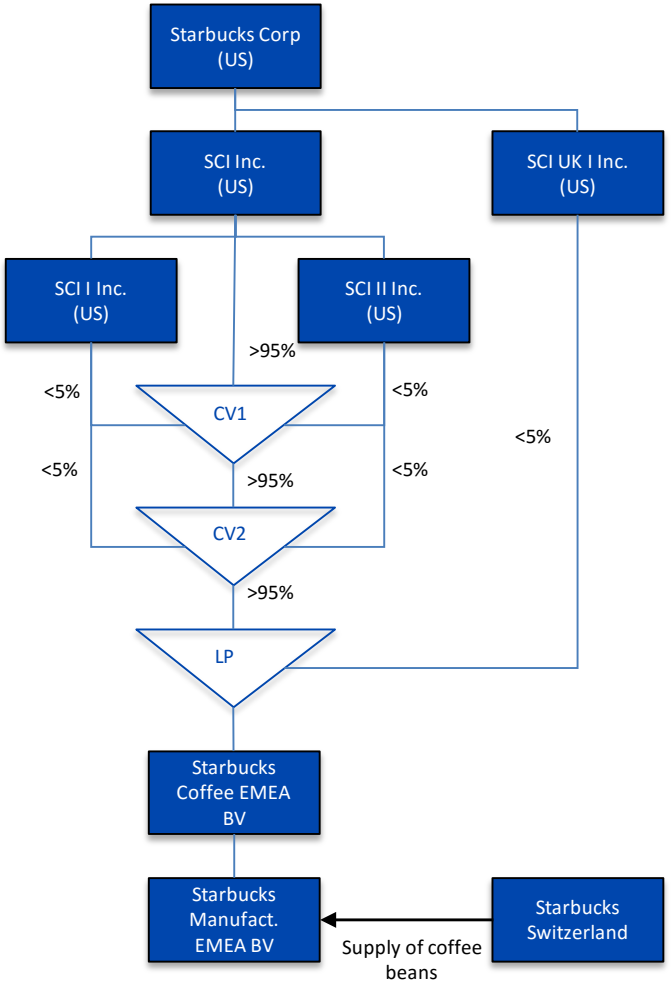
State Aid - Ireland

- Irish Government strongly rejects suggestion that there was State Aid. May drag on for some time. If Commission proceeds Irish authorities would be obliged to collect back taxes and interest
- Will Commission calculate the additional amount of tax owed, or will the Irish tax authorities be obliged to revisit the TP analyse?
- More difficult to get certain rulings/opinions now
- Ireland fully co-operated with EU Commission (as evident from the timeline) and are likely to do so again if a request is made
- Commission conceded in its press release that “the number of tax rulings issued in Ireland relating to transfer pricing arrangements is limited”
- Recent press reports in Ireland suggest Commission has asked for information relating to other taxpayers
- Commission announced in December that it would examine other jurisdictions’ regimes
- What do you do if you have a ruling, relating to pricing, already in place?

EU STATE AID – STARBUCKS

- EU Commission targeted the APA concluded in 2008 by Starbucks Manufacturing EMEA BV
- EU Commission concluded that the APA constituted state aid:
  - Rejects the APA characterization of Manufacturing BV as a low-risk toll manufacturer;
  - Questions the appropriateness of certain adjustments made to the transfer pricing comparability;
  - Questions whether the DTA were to accept Starbucks' implementation of the APA, as a result of which any residual income was paid as a royalty expense to LP.

- Response Dutch State Secretary of Finance
  - Convinced that the method and remuneration comply with the at arm's length principle which is implemented in Dutch law (in line with art. 9 OECD MTC);
  - No selective advantage: (i) APA based on OECD Transfer Pricing Guidelines and (ii) APA does not depart from the normally applicable tax regime;
  - Likely to be appealed



EU STATE AID – AMAZON

- Opening decision published on 16 January 2015, final decision expected in November 2015
- EU Commission came to the initial conclusion that APA concluded with Amazon constitutes state aid
- The European Commission found issues in particular with:
  - The transfer pricing methods – did they conform with OECD standards;
  - The license fee paid for the use of intellectual property rights not linked to output, sale or profit, but corresponded to residual profits and may not have reflected the value of the intellectual property concerned;
  - The functional analysis of the Luxembourg entity;
  - Whether the applied mark-up represented an appropriate remuneration for the activities performed;
  - The appropriateness of a floor and ceiling for the remuneration of the Luxembourg entity; and
  - The duration of the ATR.
- The Luxembourg government expressed, by means of a press release on 16 January 2015, its confidence that the investigation would show that the ATR does not constitute State Aid.

Risk indicators in State Aid cases

- Local rules differ from OECD guidelines (Apple)
- Lack of TP documentation (Amazon/Apple)
- Insufficient substantiated choice for TP method (Amazon, Apple, Starbucks)
- Benchmark lacking proper comparables (FIAT)
- Reverse engineering of price (Apple)
- Perceived fixed profit range in absolute terms or profit cap (Amazon)
- APA with a long duration or no fixed term (Amazon, Apple)
- Economic rationality of structure (Starbucks, Amazon)

Dealing with State Aid risk

- *Discover risk*: assess whether existing APAs and ATRs are State Aid "proof"

- *Explain risk*: inform and educate executive and supervisory boards, audit committees and auditors on the risk:
  - Uncertainty during State Aid procedure, additional expense
  - Unlawful state aid received by the taxpayer will be recovered by the respective jurisdiction: within a time frame of four months: going back a maximum of ten years as of the date of the formal decision, including interest.
  - Reputational risk
- *Reduce risk*:
  - Prepare robust transfer pricing documentation
  - Substantiate the choice of TP method and why it fits the activities
  - If the profit is in any way capped, explain why
  - Substantiate the outcome
  - Substantiate choices made in the benchmark more thoroughly
  - Reduce term of the ruling to 5 years
- *Fight risk*:

  assist in the entire enforcement and litigation process if an investigation by the EU Commission takes place or is upcoming. This is a technical, legal, public relations and, possibly political process that can go from the EU Commission to, eventually, the European Courts.

Thank You