ITSG Annual Conference

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Transfer Pricing

Leading Case Laws and Recent Developments

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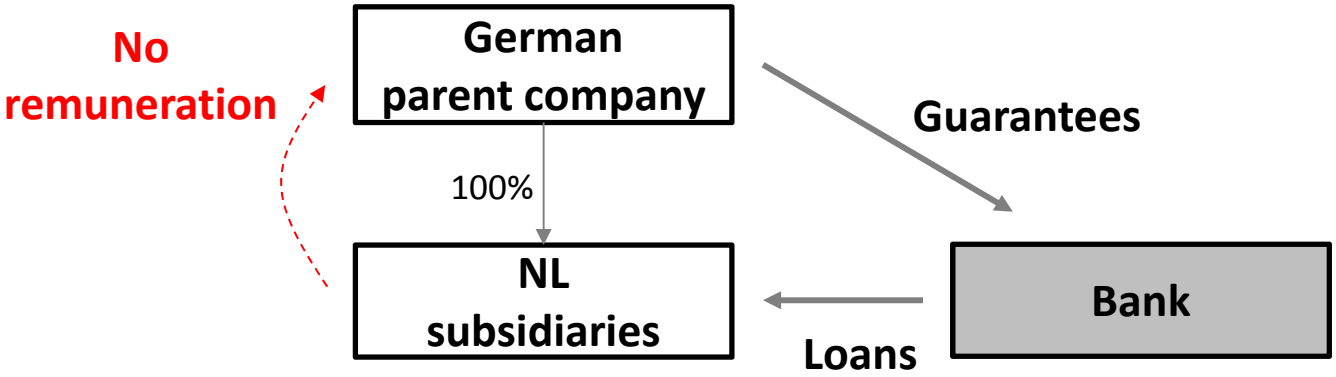
Agenda

- Update on TP Developments within the EU (focus on Germany and the Netherlands)
- Update on TP Developments in Israel
- World- Wide Leading TP Cases –
  - The Chevron Case in Australia
  - The Coca Cola case in the US
- Discussion on the implementation of BEPS TP reporting in several jurisdictions

Leading Cases within the EU

- **CJEU 31 May 2018, Hornbach-Baumarkt (C-382/16)**



Leading Cases within the EU

- **CJEU 31 May 2018, Hornbach-Baumarkt (C-382/16)**

  - German parent guarantees loans affiliates without any remuneration
  - German tax authorities argue unrelated third parties would have agreed remuneration for guarantees and hence tax fictitious income

  - Taxpayer argues before Rheinland-Pfalz Finance Court (*Finanzgericht*):
    1. German TP legislation conflicts with EU freedom of establishment as it leads to unequal treatment of transactions with other Member States (no similar corrections for domestic transactions)
    2. German legislation is disproportionate as it provides no opportunity to present commercial justification

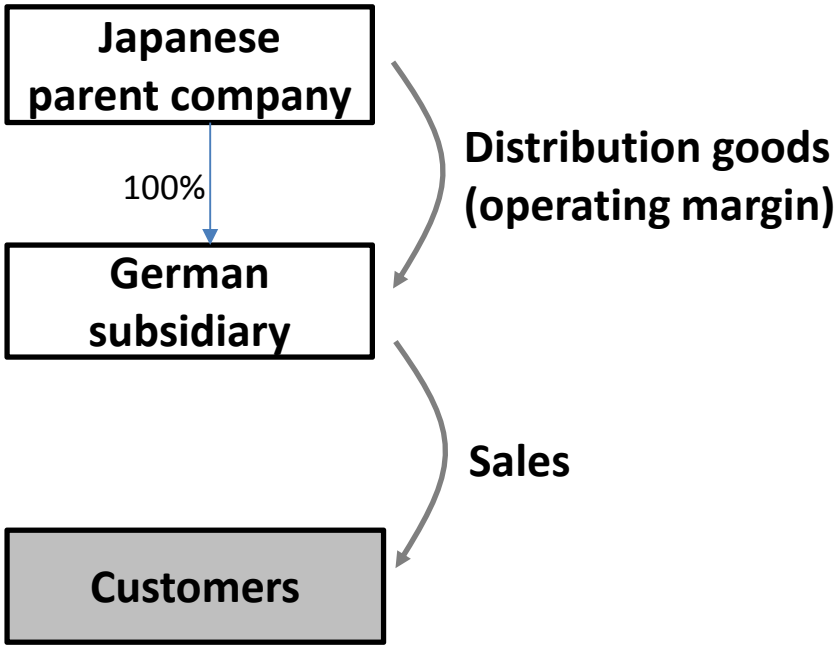
Leading Cases within the EU

- **<u>CJEU 31 May 2018, Hornbach-Baumarkt (C-382/16)</u>**

  - CJEU rules German TP legislation is consistent with EU law:
    - TP legislation inherently restricts freedom of establishment; **BUT**
    - Such restriction is justified by need to preserve balanced allocation of taxing rights between Member States
  - CJEU also confirms right to provide counter evidence:
    - Position as shareholder of non-resident company may be taken into account in determining whether there is sufficient commercial justification for not non-arm's length related-party transaction
    - Case referred back to German court

Leading Cases within the EU

- **CJEU 20 December 2017 Hamamatsu Photonics (C-529/16)**



Leading Cases within the EU

- **<u>CJEU 20 December 2017 Hamamatsu Photonics (C-529/16)</u>**

  - German subsidiary reports target profit based on APA
  - German authorities refuse refund of custom duties on year end adjustments since these cannot be allocated to individual imported goods

  - Munich Finance Court (*Finanzgericht*) requests preliminary ruling on whether transfer price can be used as customs value if composed of:
    1. amount initially invoiced (and declared); plus or minus
    2. year end adjustment using allocation key (flat-rate) without subsequent debit charge or credit

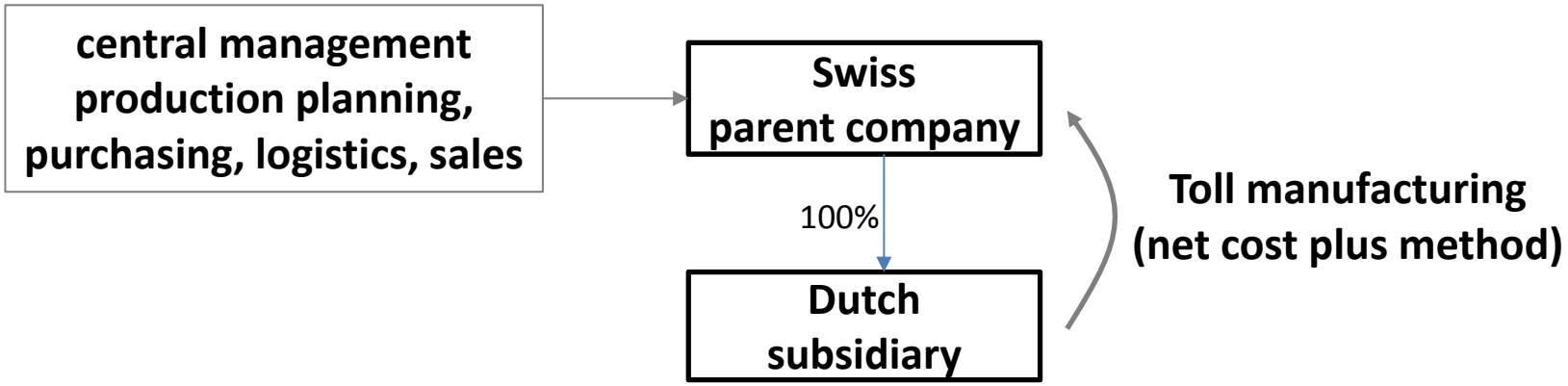
Leading Cases within the EU

- **<u>CJEU 20 December 2017 Hamamatsu Photonics (C-529/16)</u>**

  - CJEU confirms:
    1. transaction method forms basis for customs valuation, unless actual price cannot be determined
    2. adjustment of transaction value is limited to specific circumstances, such as defected or damaged goods
  - CJEU rules that absent a debit charge or credit, EU Customs Code does not allow year end adjustments using allocation key (flat-rate) to be taken into account for determining customs value
  - CJEU adds that this may be different if customs authorities can verify whether adjustment must go up or down

Leading Cases within the EU

- **Court Zeeland-West Brabant (NL), 19 September 2017**



Leading Cases within the EU

- **Court Zeeland-West Brabant (NL), 19 September 2017**

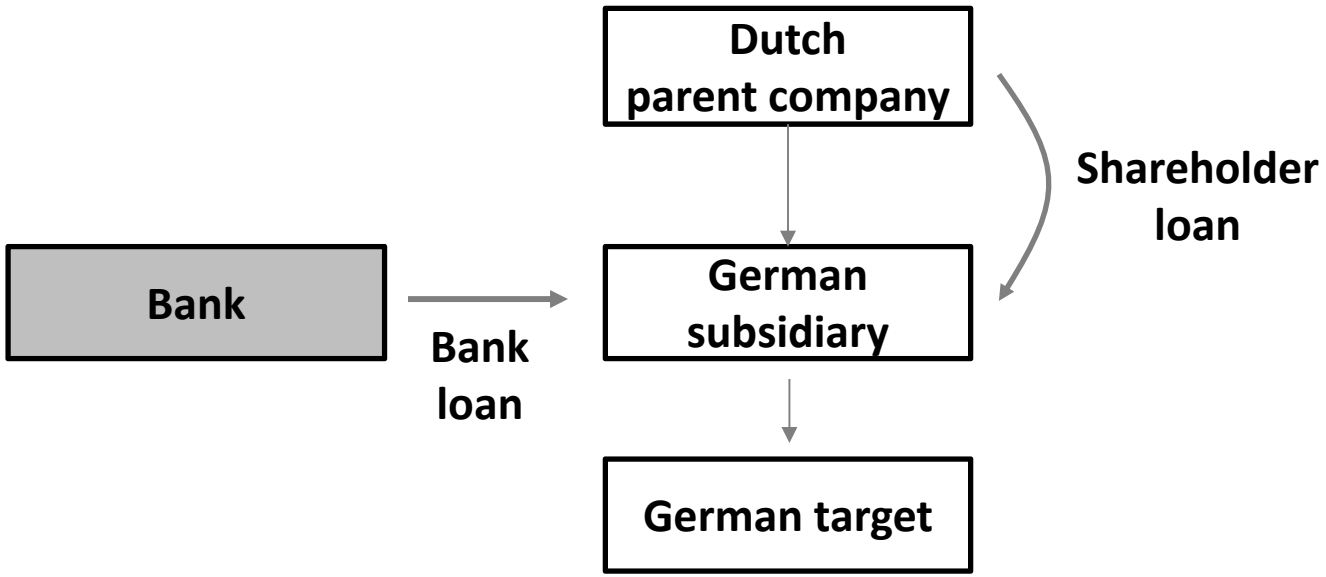
  - Swiss principal (HQ with app. 100 employees) takes on management of production planning, purchasing, logistics and sales, so that operating companies are no longer exposed to related financial risks
  - Previous legal arrangement is terminated, for which NL operating company receives compensation payment of EUR 28 million
  - Taxpayer prepares several reports to evaluate compensation
  - Toll manufacturing agreement is concluded between Swiss principal and operating companies (including NL) based on cost plus 10%
  - Taxpayer had also adequately substantiated net cost plus method used to remunerate its (toll) manufacturing function

Leading Cases within the EU

- **Court Zeeland-West Brabant (NL), 19 September 2017**
  - Dutch tax authorities argue key core functions in the Netherlands have not substantially changed upon moving headquarters to Switzerland, meaning that amount of compensation payment must be adjusted to EUR 185 million (*i.e.*, almost a factor 7)
  - The Court rules that since applicable TP documentation requirements were met, there is no ground for reversal of burden of proof
  - The Court also rules that even if TP documentation requirements had not been met, reversal of burden of proof would require identification of specific defects in taxpayer's administration
  - Dutch tax authorities have appealed against the Court's decision

Leading Cases within the EU

- **Finanzgericht Köln (Cologne, Germany), 29 June 2017**



Leading Cases within the EU

- **<u>Finanzgericht Köln (Cologne, Germany), 29 June 2017</u>**

  - German company finances (domestic) acquisition with mixture of:
    1. bank debt
    2. shareholder loan from Dutch parent
  - Taxpayer performs benchmark study to determine interest on shareholder loan
  - German tax authorities ignore outcome of benchmark study arguing external CUP (read: Bloomberg search for comparable instruments) used for TP report is not desirable / necessary in situations where internal CUP (bank loan) is also available

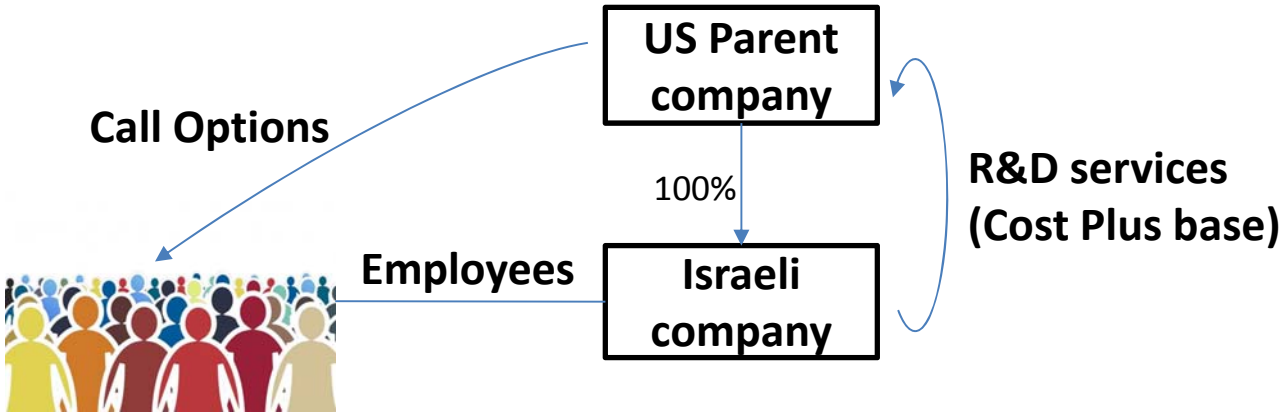
Leading Cases within the EU

- **<u>Finanzgericht Köln (Cologne, Germany), 29 June 2017</u>**

  - Taxpayer argues that T&C of bank debt are not sufficiently similar to T&C of shareholder loan, meaning that internal CUP cannot be used
  - The Finance Court confirms tax authorities' view that maximum interest deductible on shareholder loan is equal to bank interest, although possibly adjusted for differences in terms of security rights
  - Query whether German practice is in line with OECD TP guidelines
  - Query whether using corporate bonds (rather than syndicated loans) as external CUP for interest benchmarks would change outcome

Leading Cases in Israel

- **Kontera and Fnisar, April 2018 (Israeli Supreme Court)**



Leading Cases in Israel

- **Kontera and Finisar, April 2018 (Israeli Supreme Court)**

  - The Court addressed the question whether companies using the cost plus method should include stock-based compensation costs in the cost plus base calculation.
  - The Court accepted the ITA's position that stock-based compensation costs are an integral part of the business operation and accordingly should be included in the cost plus base calculation.

Leading Cases in Israel

- **Stock-based compensation costs**

  - Similar dispute was discussed in the US Court of Appeals in the **Xilinx case**, which addressed the question whether Stock-Based Compensation (SBC) should be included in the costs shared under a cost sharing arrangement (CSA).
  - The Court held that a CSA did not have to include SBC costs under the applicable regulations at that time, based on the fact that arm's length parties do not share SBC costs.

Leading Cases in Israel

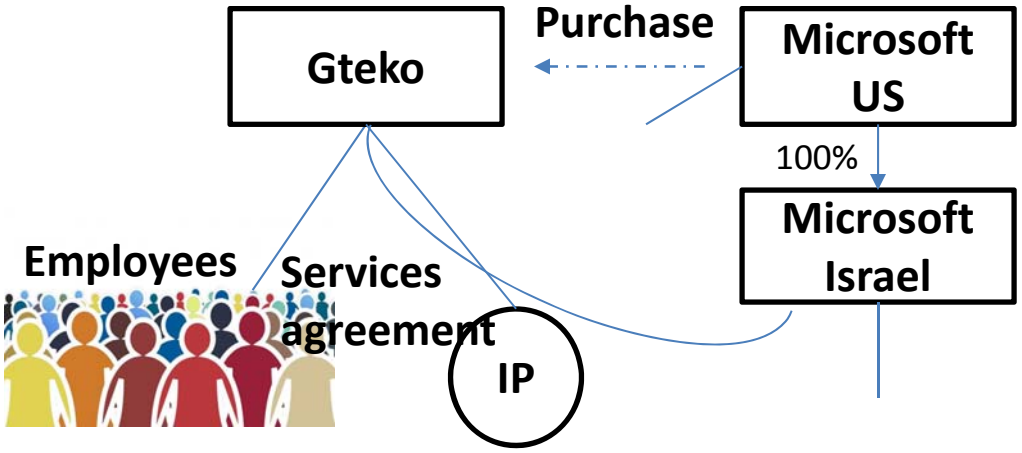
- **Stock-based compensation costs**

  - Following the Xilinx case, the regulations were amended so that CSA's must include SBC costs. The new regulations were challenged in the **Altera case**, which addressed the inclusion of SBC costs under a CSA according to the new regulations. The Court held that the new regulations validly require SBC to be included under a CSA.

Leading Cases in Israel

- **<u>Gteko Ltd (Microsoft), June 2017 (Israeli District Court)</u>**

  - The Court addressed the question whether a transfer of IP by an Israeli company to a US company, soon after the US company acquired the Israeli company, should be determined as a stand alone transfer or as a sale of the entire activity (as stated by the ITA).



Leading Cases in Israel

- **<u>Gteko Ltd (Microsoft), June 2017 (Israeli District Court)</u>**

  - The court ruled with the ITA's approach that the value of the transferred IP asset should reflect the entire value of the selling company, which is significantly higher.

Recent Developments

- **<u>“Safe Harbor” Rules</u>**

  - The ITA recently published two safe harbor circulars stating the ITA's expected profit levels for marketing services and for low-risk distributorship activities carried out in Israel by Multinational Entities ("MNE"), as well as providing guidance on non-value-added services.

Recent Developments

- **“Safe Harbor” Rules**

  - Circular 11/2018 details the expected transfer pricing methods to be used for different distributorship and marketing services transactions.
  - Circular 12/2018 is of more importance since it details the safe harbor rules for several types of transactions, based on the OECD Transfer Pricing Guidelines.
    - 5% markup for low-value-added services.
    - For marketing services, 10-12% cost plus rate.
    - An operating margin of between 3-4% for the low-risk distributor model.

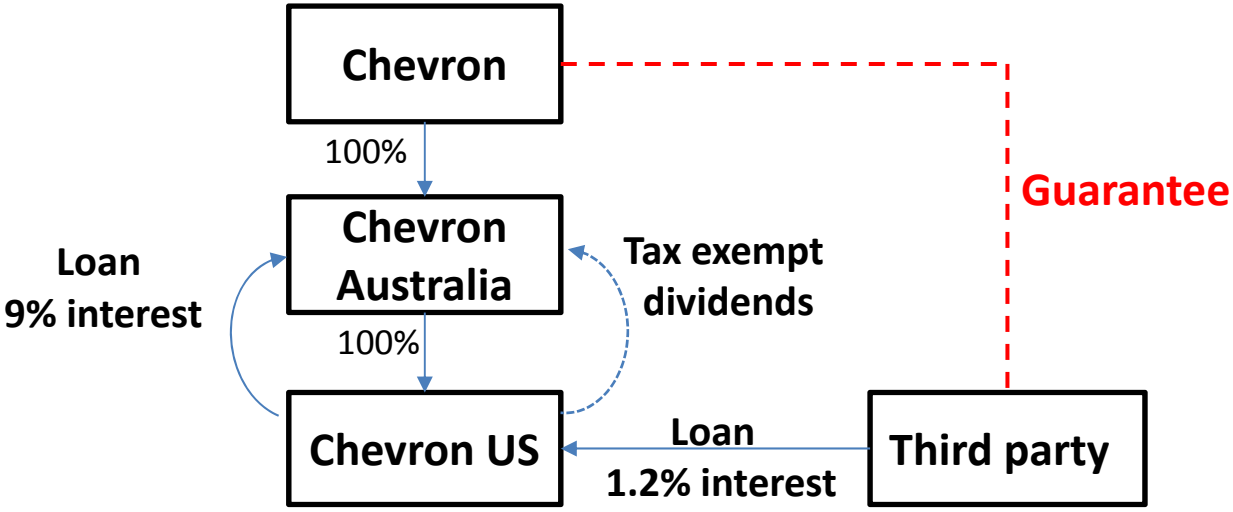
Recent Developments

- **<u>The Importance of a supporting TP Study</u>**

  - This issue was addressed by the Israeli Supreme Court in the Kontera and Finisar case.
  - The burden of persuasion rests on the taxpayer to establish that the terms of the transaction are arm's length terms.
  - The burden of proof will be with the tax authority only if the taxpayer have submitted all required documentation, including a TP study, supporting his claim that the intercompany prices are in accordance with the arm's length principle.

World- Wide Leading TP Cases

- **Chevron, April 2017 (Federal Court of Australia)**
  - Chevron US borrowed money at an interest rate of 1.2% and then made a loan at 9% to the Australian parent company. The loan increased Chevron Australia's costs and reduced taxable profits. The interest payments, which was not taxed in the US, came back to Australia in the form of tax free dividends.



World- Wide Leading TP Cases

- **Coca Cola Co v. Commissioner (USA)**

  - In 2015 Coca Cola received a notice of deficiency for $3.3 billion in additional taxes for an 2007 – 2009 audit.
  - The IRS argues that the comparable profit method is the best method to be used.
  - The CPM method would result in a transfer pricing adjustment of almost $10 billion.
  - IRS and Coca Cola agreed to the method used – the 10-50-50 method – in a 1996 audit closing agreement.
  - No formal “advance pricing agreement” was requested.

World- Wide Leading TP Cases

- **Coca Cola Co v. Commissioner (USA)**

  - The closing agreement covered 1987 – 1995.
  - 5 Subsequent audits covering the next 11 years (until 2006) resulted in the IRS concluding: “the continuing application of the closing agreement’s terms and conditions to post 1995 years seems appropriate”.

Implementation of BEPS TP Reporting

- **Preparing for Country-by-Country (CbC) Reporting**
  - The OECD has adopted a 3-tiered approach for TP documentation, targets to result in more information disclosure on Multinational Enterprises (MNEs) (BEPS Action 13).
  - 71 countries already implemented the CbC reporting.

Master File	Local File	CbC
• An overview of the MNE group business	• Detailed information relating to specific intercompany transactions	• Aggregate jurisdiction-wide information on the global allocation of income, taxes, and indicators of economic activity

Implementation of BEPS TP Reporting

- **Preparing for Country-by-Country (CbC) Reporting**

  - The disclosed information under the CbC reporting will be shared amongst all the jurisdictions in which the MNE operates, giving the relevant tax authorities unprecedented accesses to high-level information regarding MNEs' global business operations and TP policies.
  - While preparing their TP policies, MNEs will need to take into account worldwide consideration and articulate consistent TP positions from a global perspective.