AIJA Tenth Annual Tax Conference
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Cross Border Transfer of Value: Permanent Establishments and Exit Taxation

- Panel Discussion -

Panel members

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Agenda for this morning

1. Panel discussion on PE issues and exit taxation

Coffee break

2. Round table discussion and case studies

Current legal framework

- PE Definition: Article 5 OECD MC

- Attribution of profits to a PE:
  - Attribution of profits Art. 7 OECD MC (2010)
    - No legal arrangement in place / PE does not own assets
    - Separate entity approach

  - Attribution of profits to PE report (2010): Authorized OECD Approach "AOA".
    - Two step approach
    1. Allocation of functions, assets and risks (FAR) to PE
    2. Determine at arm's length pricing

Current legal framework

- Exit taxation regarding transfer of assets between head office and PE falls under scope of EU Freedom of Establishment: (e.g.*C-657/13 Verder LabTec GmbH & Co. KG v Finanzamt Hilden*)

International developments

1. BEPS Action Plan

   – BEPS Action 7. Preventing the artificial avoidance of PE status
     - Commissionaire arrangements Art. 5(5) MC
     - Preparatory or auxiliary activities Art. 5(4) MC
     - Splitting up of contracts Art. 5(3) MC
     - Artificial fragmentation of operations

   – Public Discussion Draft 5 (Definition of PE) – Interpretation and application of Article 5 OECD MC

International developments

1. BEPS Action Plan

   – Implementation of BEPS via multilateral instrument

   – Agreement was reached in November 2016, signing in June 2017

   – After ratification, MI will enter into force and will amend tax treaties concluded

International developments

2. EU Anti Tax Avoidance Directive

"Exit taxes have the function of ensuring that where a taxpayer moves assets or its tax residence out of the tax jurisdiction of a State, that State taxes the economic value of any capital gain created in its territory even though that gain has not yet been realised at the time of the exit".

- EU Directive 2016/1164 of 12 July 2016 / article 5
- ATAD does not include TP guidelines

International developments

2. EU Anti Tax Avoidance Directive

Article 5: unrealized hidden reserves on assets should be taxed in case:

a) a transfer of assets from head office to its PE in another MS or in a third country;

b) transfer of assets from PE in a MS to head office or another PE in another MS or in a third country,

c) a taxpayer transfers its tax residence to another MS or to a third country

d) a taxpayer transfers the business carried on by its PE from a MS to another MS or to a third country

International developments

3. Proposal for EU CC(C)TB

- CC(C)TB proposal of October 2016 includes an exit taxation regime similar to ATAD

- Important difference is that the CC(C)TB does not include a tax payment deferral regime

Transfer of value

Circumstances of a transfer of value involving a PE

1. Transfer of single assets
2. Transfer of legal seat or place of effective management
3. Business reorganization and transfer of functions
4. Business reorganization and PE reclassification

The impact of the exit taxation on cross border transfer of value

Taxpayers' emigration and the reallocation of taxing rights

- Departure taxes
  - "**Exit taxes**" → taxes levied immediately before a person ceases to be a resident of a State on accrued capital gains
  - "**Trailing taxes**" → taxes levied after a change of residence over the gain realized on actual alienation
- The main purposes:
  - Protecting the taxing rights of the former residence State
    - Preserving the right to tax gains accrued while the taxpayer is resident
  - Preventing a double non-taxation when a new residence State does non tax capital gains

Taxpayers' emigration and the reallocation of taxing rights

- Application of DTC?
  - In absence of a special provisions, capital gains are generally taxable only in the current State of residence under Article 13(5) of the OECD Model
  - To the extent that such exit tax is levied when a person is still a resident of the State that applies the tax and does not extend to income accruing after the cessation of residence, nothing in the Convention, and in particular in Article 13, prevents the application of that form of taxation
  - Thus, DTC do **not** prevent the application of domestic exit taxation on accrued capital gains immediately before ceasing to be a resident

Taxpayers’ emigration and the reallocation of taxing rights

- Double taxation issues?
  - The State of residence taxes the entire gain (computed by referring to the historical cost basis) when the asset is actually alienated (including the gain that has been subject to the exit tax in the former residence state)
  - Special provisions allowing step-up in value
  - BEPS Final Report on Action 6, “*Preventing the Granting of Treaty Benefits in Inappropriate Circumstances*” →MAP

    “[…] *each State should provide relief as regards the residence-based tax that was levied by the other State on the part of the income that accrued while the person was a resident of that other State. This would mean that the new State of residence would provide relief for the departure tax levied by the previous State of residence on income that accrued whilst the person was a resident of that other State, except to the extent that the new State of residence would have had source taxation rights at the time that income was taxed*”

EU Anti Tax Avoidance Directive 2016/1164

- Objective and scope of exit taxes
  - Ensuring that where a taxpayer moves assets out of the tax jurisdiction of a State, that State taxes the economic value of any capital gain created in its territory even though that gain has not yet been realised at the time of the exit
  - Transfers of assets between a parent company and its subsidiaries fall outside the scope of the envisaged rule on exit taxation

EU Anti Tax Avoidance Directive 2016/1164

- Cases in which taxpayers are subject to exit tax on unrealized capital gains (Article 5)
  - Transfer of <u>tax residence</u> to another MS or to a 3rd country, except for those assets which remain effectively connected with a PE in the first MS
  - Transfer of <u>assets</u> from head office to its PE in another MS or in a 3rd country
    - Eg. Branch exemption regimes
  - Transfer of <u>assets</u> from its PE in a Member State to its head office or to a PE in another MS or in a 3rd country
  - Transfer of a <u>business</u> carried on by its permanent establishment from a MS to another MS or to a 3rd country

EU Anti Tax Avoidance Directive 2016/1164

- Deferral (not suspension) is possible for intra-EU transfers and transfers to EEA-states
  - installments over 5 years
  - deferral option in case of EEA States can only occur in case there is an agreement in place which is equivalent to Directive 2010/24/EU (recovery of tax claims)
  - interest may be charged
  - guarantee may be required in cases of demonstrable and actual risk of non-recovery unless liability transferred to another group member resident for tax purposes in the said MS
- The taxpayer have the right to either immediately pay the exit tax or defer payment

EU Anti Tax Avoidance Directive 2016/1164

- Step-up in value for assets transferred
  - "*Where the transfer of assets, tax residence or the business carried on by a permanent establishment is to another Member State, that Member State shall accept the value established by the Member State of the taxpayer or of the permanent establishment as the starting value of the assets for tax purposes, unless this does not reflect the market value*" (article 5(5))
  - Preventing double taxation
  - Transfers from a **third country** to a **Member State**? → some countries provides for a domestic step-up in value (e.g. Italy if certain conditions are met)

Discussion on the latest court rulings of the ECJ

- ECJ cases → freedom of establishment
  - Case C-657/13, *Verder LabTec*
    - Partial or total transfer of assets to a PE in another MS
    - Disclosure of unrealized capital gains + taxation of such gains + staggered recovery over 10 annual instalments is not contrary to art. 49 TFEU
  - *Case C-503/14, EC v Portugese Repulic*
    - Transfer of assets from Portugal to a company with legal seat or effective management in another MS – Immediate taxation of hidden reserves
    - Deferral only if the transferee company is in Portugal
    - Not compliant with art. 49 TFEU

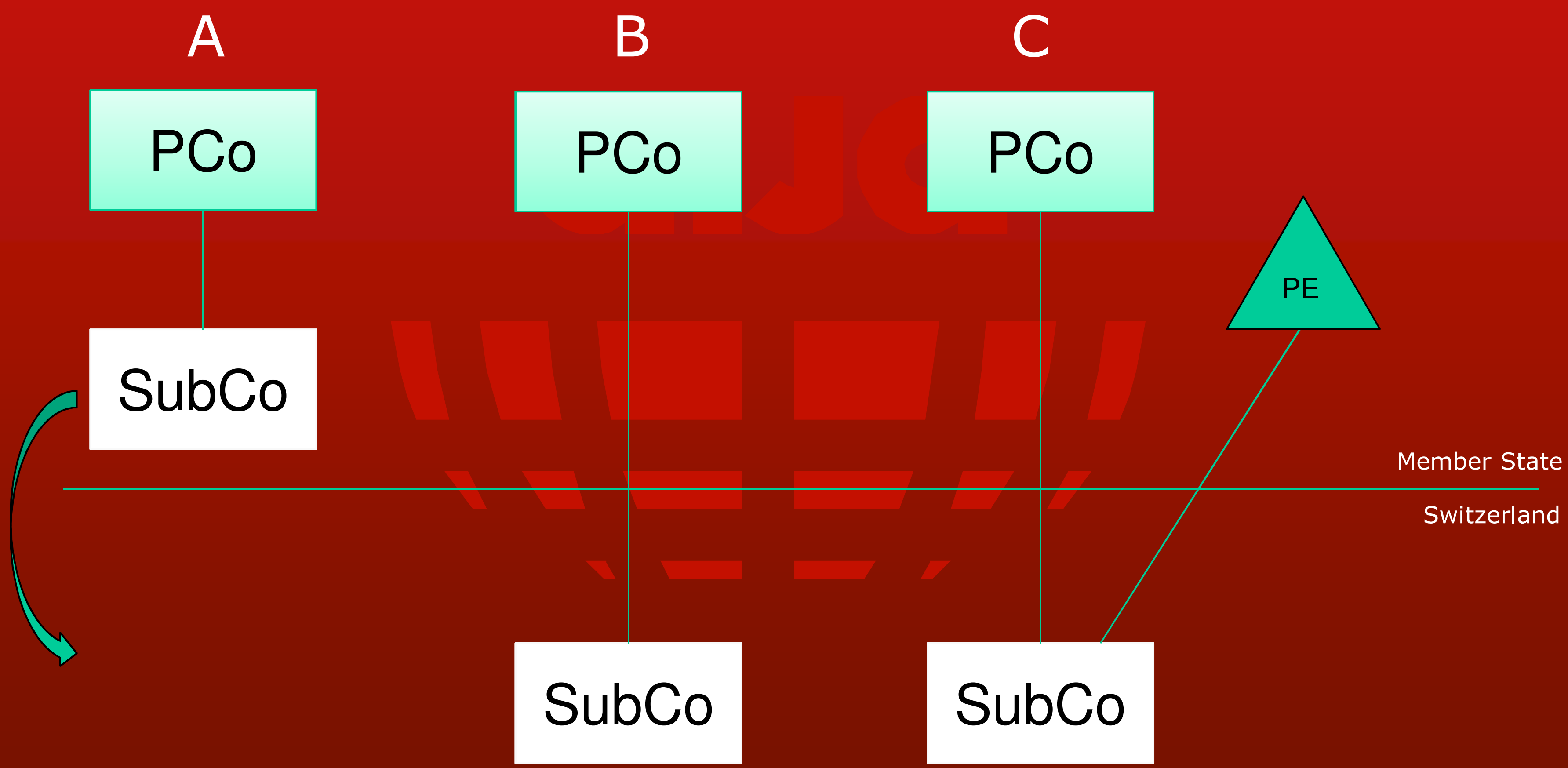
International developments on exit taxation

- Art. 29 EU Common Corporate Tax Base (CCTB) – proposal – 25 October 2016
  - No tax deferral regime

- The impact of Article 5 of ATAD on domestic systems
  - E.g. Italian provisions on exit taxation
    - Suspension vs. deferral
    - Single assets vs. business

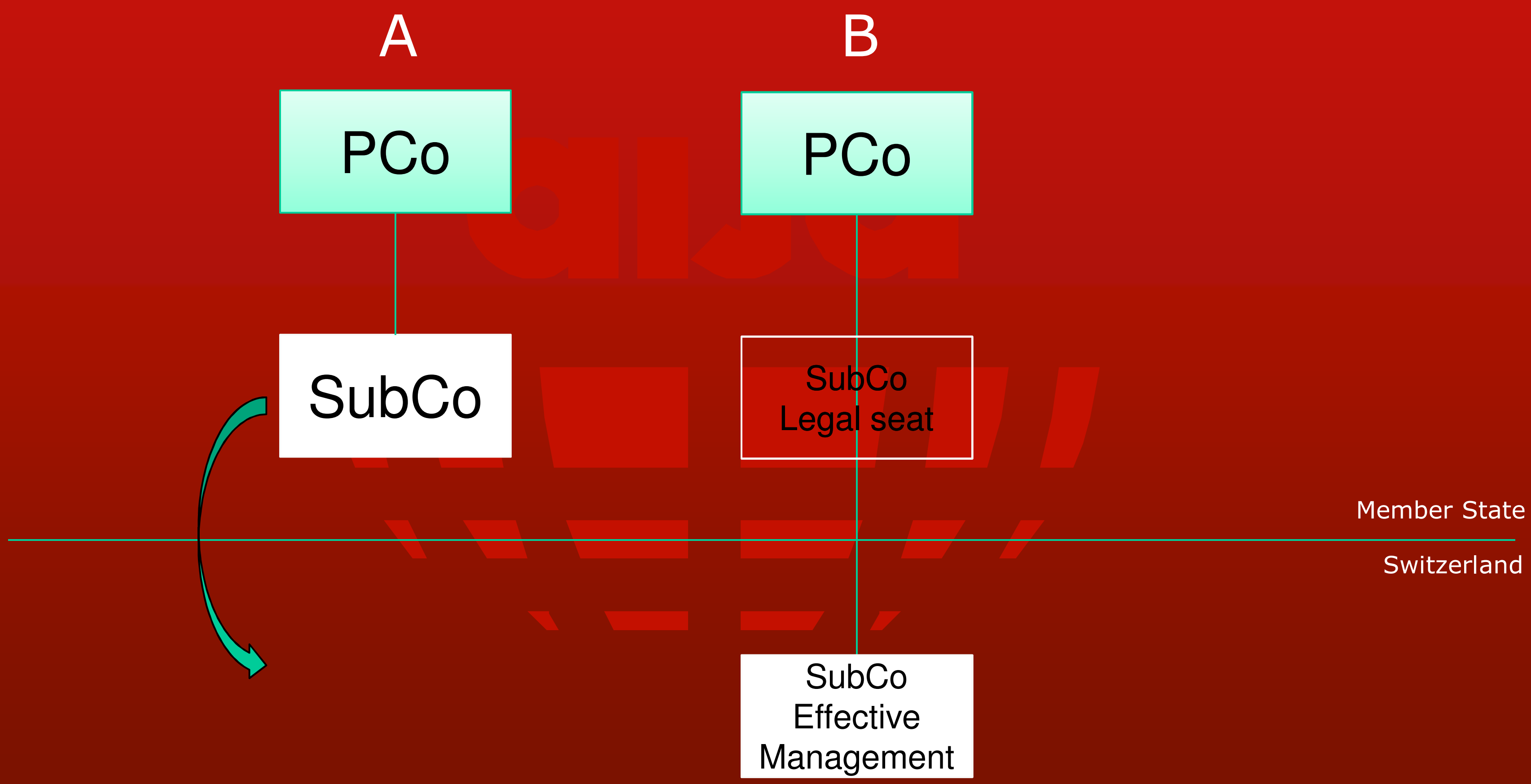
Example 1

- Cross-border transfer of legal seat



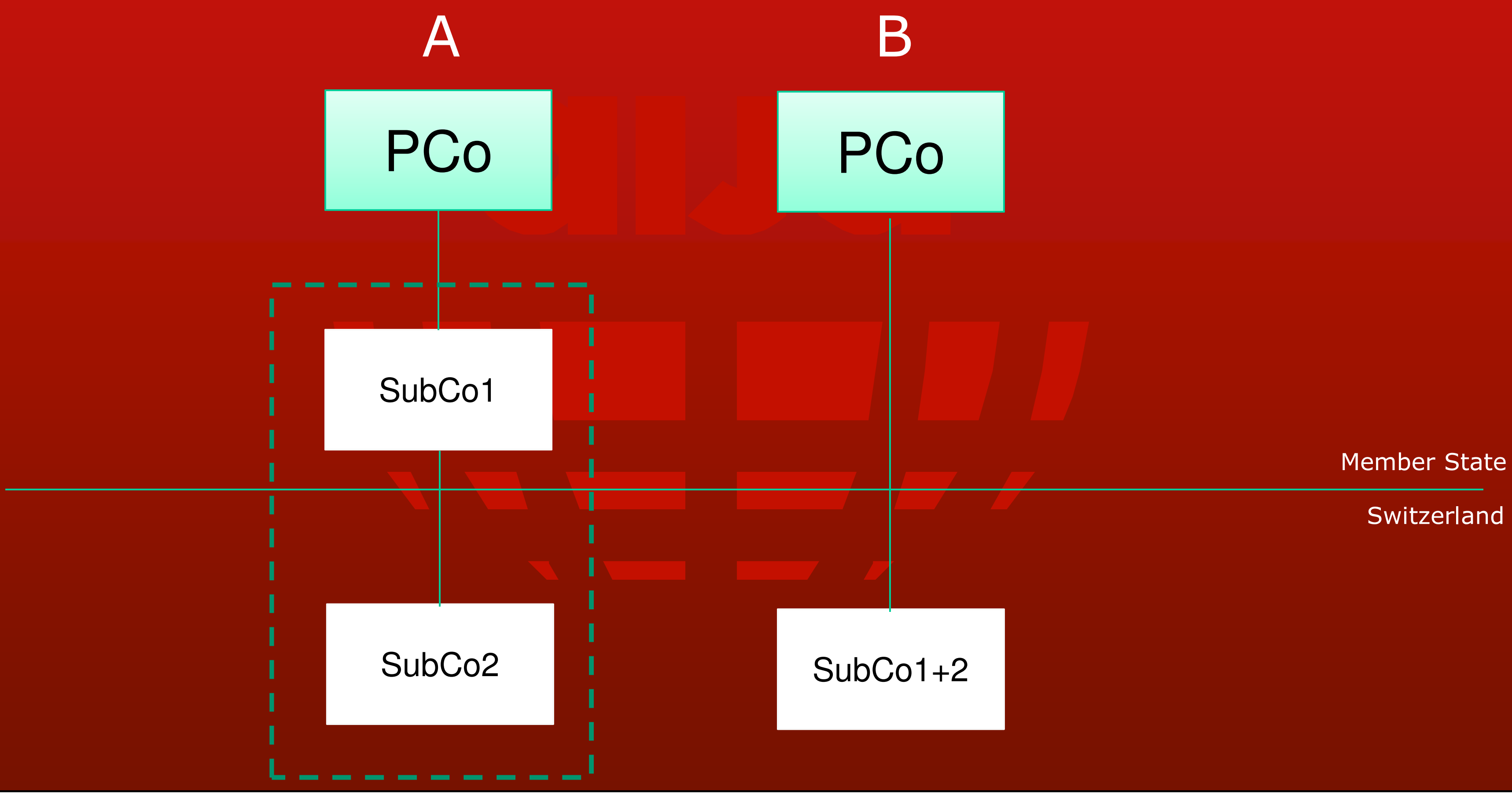
Example 2

- Transfer of effective management



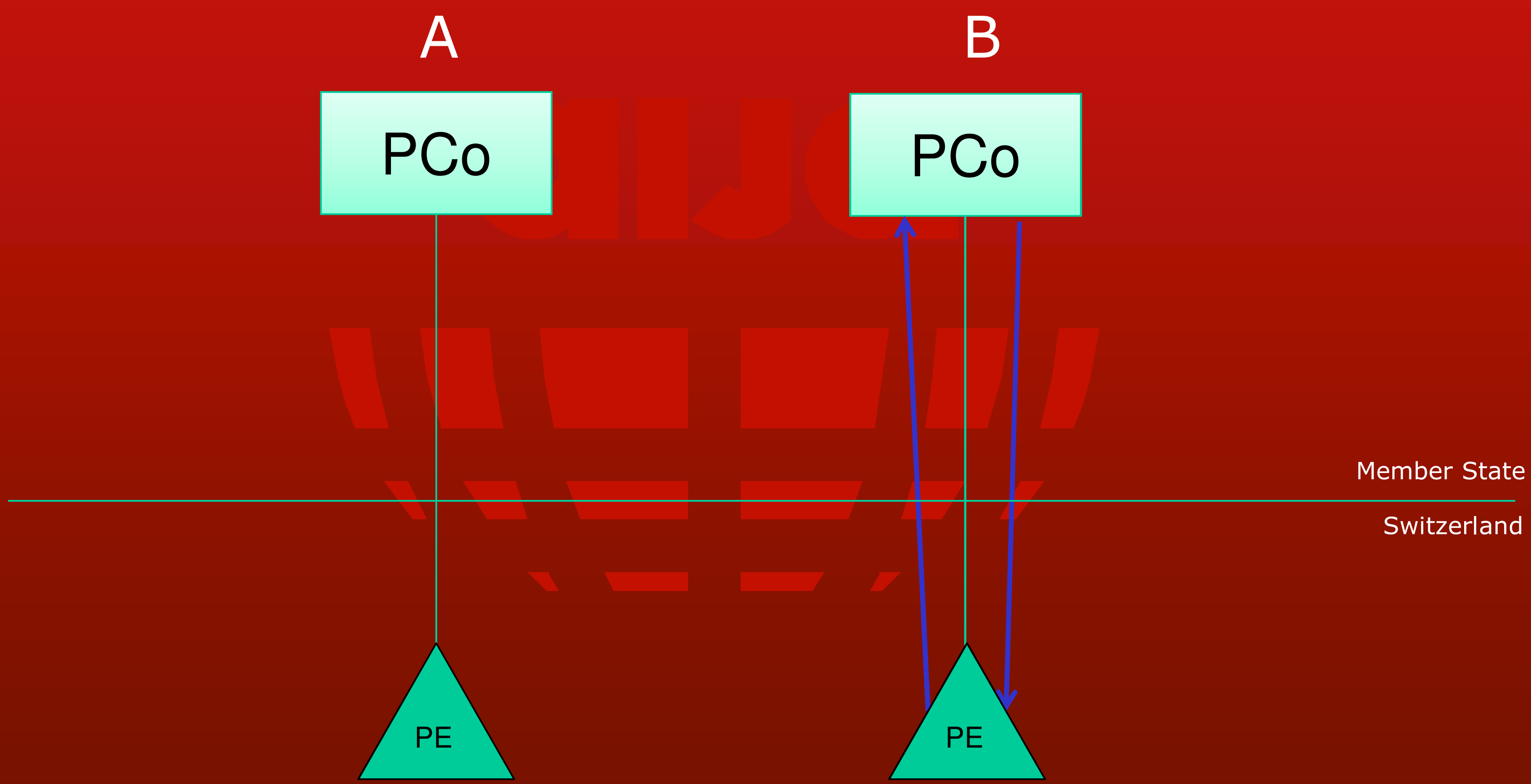
Example 3

- Cross-border downstream merger



Example 4

- Transfer of asset(s) to PE and vice-versa



Transfer of value to PE
- Business reorganization and transfer of functions -

Transfer of business functions to PE:

- General concept under German law and now EU law:
  - Starting point: arm's length principle for related parties in Foreign Tax Act
  - "Exit charge" on transfer of functions, i.e. not single assets or entities
  - Since incorporation of AOA applicable to PE related "dealings"
  - Valuation based on future profits connected to the transferred function
  - Subject to valuation by standard transfer pricing methods

Transfer of business functions to PE:

- Requirements
  - No arm's length valuation identifiable
  - Function transferred with associated opportunities, risks, assets and other benefits from head office to PE (or related parties)
  - In fact only applicable in cross border situations

Transfer of business functions to PE:

- Exemptions
  - Creation of new functions
  - Duplication of functions
  - Transfer of assets or rendering of services which would between third parties not be considered as sale and purchase of a function
  - Limitations of functions

Transfer of business functions to PE:

- Consequences
  - "Exit tax" on future profits, IP, know how
  - Valuation of "transfer package" (including business value) based on transferred functions, risks, opportunities, assets and other benefits
  - Application of regular prospected income methods for valuation of companies (income after taxes or discounted cash flow) with respect to transferred business / function
  - Adoption to actual profits within five years
  - Conflict with exit taxation on transferred assets (see below)
  - Conflict with EU law

Transfer of business functions to PE:

- Art. 5 para. 1 EU Anti Tax Avoidance Directive
  - unrealized hidden reserves on assets should be taxed in case: a taxpayer transfers the business carried on by its PE from a MS to another MS or to a third country
  - Taxation of hidden reserves in assets transferred due to the transfer of a function/business
  - However, no taxation of “profit potential” like in the German system
  - Risk of double taxation because EU countries will limit the tax value to the market value of the asset as set forth in the ATAD
  - Instalments over 5 years available

Transfer of value to PE
- PE reclassification under OECD MC / BEPS -

1. PE reclassification under OECD MC / BEPS

General overview

- Cross border transfers of assets, functions and risks, in the context of business reorganizations, **may lead to a PE status** in the host country, according to article 5 OECD MC*.*
- *Prospective* changes in article 5 OECD MC under **Action 7** BEPS. Multilateral Convention (June 2017)
- Aim to tackle practices of MNE leading to an artificial avoidance of the PE status
- Focused on: (i) Commissionnaire agreements or similar
  (ii) Preparatory or auxiliary activities
  (iii) Artificial fragmentation of operations

1. PE reclassification under OECD MC / BEPS

Commissionnaire agreements or similar

- "*A commissionnaire agreement may be loosely defined as an arrangement through which a person sells products in a State in its own name but **on behalf of** a foreign enterprise that is the owner of these products*". (Action 7. Final report)

- New Article 5.5 and 5.6 of the OECD MC: Where a person "habitually concludes contracts/habitually plays the principal role leading the conclusion of contracts/ that are routinely concluded without material modification by the enterprise".

1. PE reclassification under OECD MC / BEPS

Commissionnaire agreements or similar

– In the name/on behalf of WHOM? "and these contracts are

a) In the name of the enterprise; **OR**

b) for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or

c) for the provision of services by that enterprise

- Case law: Zimmer (2010)/Dell Noruega (2011)/Boston Scientific (2012) -old formal approach- vs Dell Spain (2016) -new economic approach-.

1. PE reclassification under OECD MC / BEPS

Preparatory or auxiliary activities

- Article 5.4 of OECD MC
- Criteria to determine if the activity is preparatory or auxiliary:
- ✓ Duration, assets and employees utilized, etc
- ✓ Is it an essential and significant part of the business considering the enterprise as a whole?
- Safe harbour vs open list of examples
- "*Vis atractiva*" of other non preparatory or auxiliary activities in the same place.

1. PE reclassification under OECD MC / BEPS

Artificial fragmentation of operations

- New paragraph in article 5 OECD MC

- New concepts:

"**overall** activity resulting from the **combination** of activities"
"complementary functions that are part of a <u>**cohesive business operation**</u>".

- Case law. Borax (2011) / Roche (2012)
- Binding rulings: "complex operating structure"

2. Attribution of profits to PE (AoP)

- OECD Public Discussion Draft. Sep 2016: Additional guidance for AoP to PE under article 7 OECD MC
- Actions 8-10 BEPS
- Commentary to article 7 OECD MC/2010 Report on AoP to PE (AOA)
- For instance, if the *commissionnaire* qualifies as a dependent agent (DAPE) of the non resident associated company, under new articles 5.5 and 5.6 OECE MC, and the *commissionnaire* is a resident associated enterprise (DAE), a **factual and functional analysis** must be conducted for AoP to the PE.

2. Attribution of profits to PE (AoP)

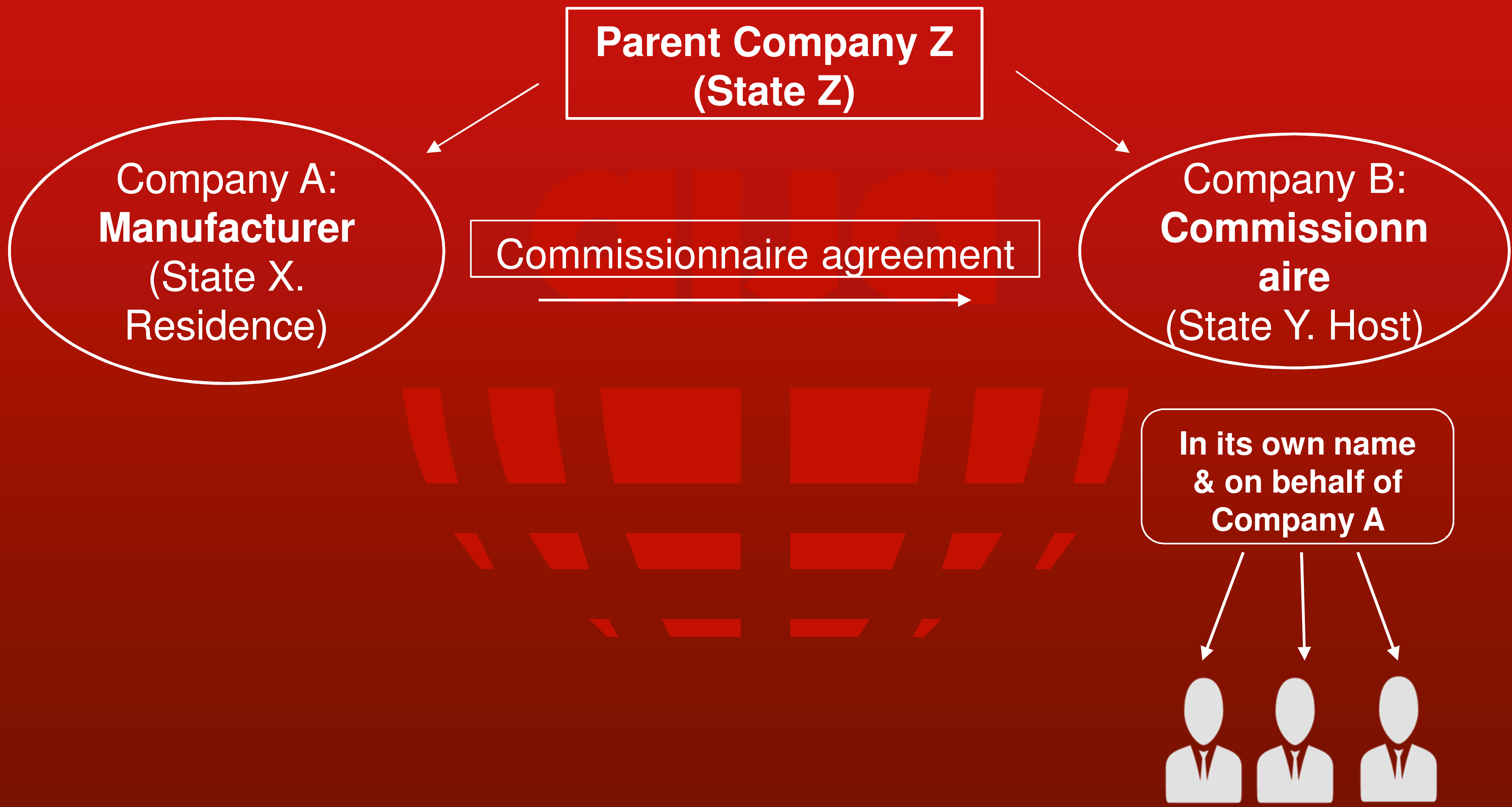
1st Step: identification of the activities carried on through the PE

- Functional and factual analysis
- Identify the economically significant activities and responsibilities undertaken through the PE
    - Treat the PE as a distinct and separate enterprise.
    - Identify the key entrepreneurial risk-taking (“KERT”) functions and significant people functions (“SPF”) relevant to the business being undertaken.
    - Allocate the assets of, and risks in, the business based on the (geographical) location of the KERTs.
    - Attribute appropriate capital to support the assets and risks (“free capital”).
    - Recognize and determine the nature of dealings between the PE and other parts of the same enterprise that can be appropriately recognized.

2nd Step: determine the PE remuneration

- By reference to the functions performed, assets used and risk assumed by the enterprise through the PE

2. Attribution of profits to PE (AoP)



2. Attribution of profits to PE (AoP)

Company B: Commissionnaire
(State Y- Host)

Atribution of profits

Factual & functional analysis

Company B as DAPE of Company A

Company B as DAE

<u>Risks:</u>
- Exchange rates
- Inventory
- Bad debt (credit risk)
- Claims
- Etc

<u>Assets</u>:
- Fixed assets
- Stock
- Customer base

<u>Functions</u>:
- Marketing & advertising
- R&D
- Identifying customers
- Processing Customer's orders
- Invoicing
- Sales' strategy
- Pricing policy
- Logistics

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- Round table discussion -

Case study X: Business restructuring (1/2)

- Company A (State X) and Company B (State Y) are part of group Z (State Z).
- A and B had a distribution agreement in which A sold products to B and B sold the products in State Y in its own name and behalf.
- Company Z posses directly o indirectly >50% of the beneficial interest of Company A and B.
- Company B distributes exclusively the products manufactured by Company A in State Y.

Case study X: Business restructuring (2/2)

- In year 2017, a new commissionnaire agreement is signed between A and B
- Company B transfers to Company A its customer base, its stock and its fixed assets.
- There is a shifting of business risks and functions to Company A.
- What are the tax consequences?

Case study X: Business restructuring & new PE definition: FORMER structure

Parent Company Z
(State Z)

Company B:
Full risk distributor
(State Y)

Distribution agreement

Company A:
Manufacturer
(State X)

<u>Risks:</u>
- Exchange rates
- Inventory
- Bad debt (credit risk)
- Claims, etc

<u>Assets</u>:
- Fixed assets
- Stock
- Customer base

<u>Functions</u>:

- R&D
- Marketing & advertising
- Identifying customers
- Processing Customer's orders
- Invoicing
- Sales' strategy
- Pricing policy
- Logistics, etc

In its own name & behalf

Case study X: Business restructuring & new PE definition: NEW structure

Parent Company Z (State Z)

Company A: **Manufacturer** (State X)

Commissionnaire agreement

Company B: **Commissionnaire** (State Y)

Risks:
- Exchange rates
- Inventory
- Bad debt (credit risk)
- Claims, etc

Assets:
- Fixed assets
- Stock
- Customer base

Functions:

- R&D
- Marketing & Advertising
- Sales' strategy
- Pricing policy
- Logistics, etc

Functions:

- Implementing marketing & advertising policy
- Identifying customers
- Processing customer's orders
- Invoicing

In its own name & on behalf of Company A

Case study – Alternative A (1/2):

- Company A (State X) and Company B (State Y) are part of group Z (State Z).
- A and B had a distribution agreement in which A sold products to B and B sold the products in State Y in its own name and behalf.
- Company Z posees directly o indirectly >50% of the beneficial interest of Company A and B.
- Company B distributes exclusively the products manufactured by Company A in State Y.
- In year 2017, the distribution agreement is replaced by a

Case study – Alternative A (2/2):

- Company B does not transfers its customer base, its stock and its fixed assets to Company A.
- However, A assumes the credit risks. The fee payments to be paid to A reflect the reduced function of B.
- What are the tax consequences?

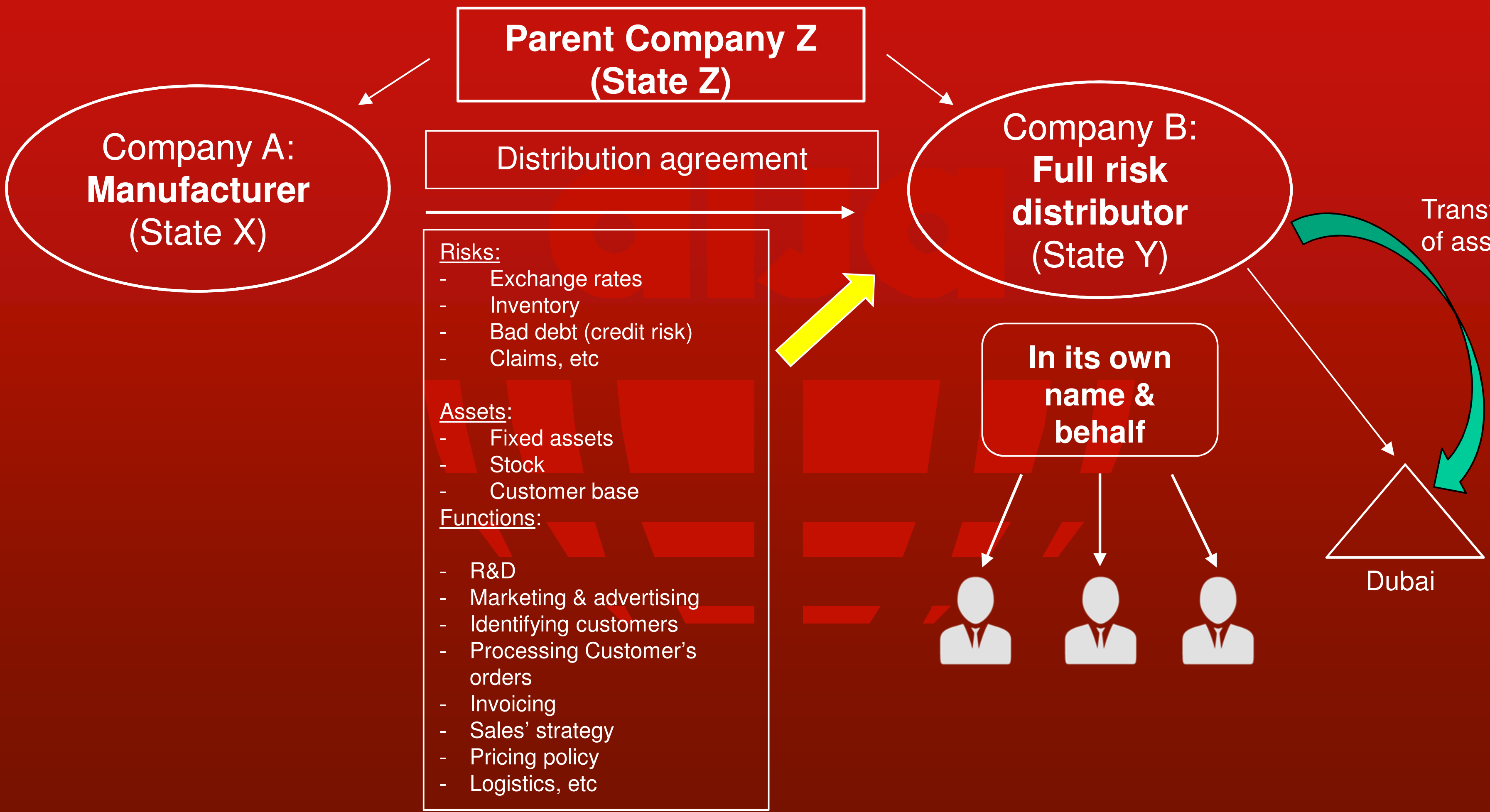
Case study – Alternative B (1/2):

- Company A (State X) and Company B (State Y) are part of group Z (State Z).
- A and B had a distribution agreement in which A sold products to B and B sold the products in State Y in its own name and behalf.
- Company Z posees directly o indirectly >50% of the beneficial interest of Company A and B.
- Company B distributes exclusively the products manufactured by Company A in State Y.

Case study – Alternative B (2/2):

- In 2017, Company B wants to distribute the products manufactured by Company A also in State W (Dubai)
- Company B decides to operate in Dubai through a PE transferring its MEA customer base, part of its stock and its fixed assets.
- What are the tax consequences?

Case study X: Business restructuring & new PE definition: FORMER structure



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