

## Intangibles, a key source of growth

After the crisis, a new tax landscape

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## Intangibles, a key source of growth

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## Outline

- Introduction
- Case studies
  - French case
  - German case
  - UK case
  - Corporate taxation of IP, royalties and R&D in Hungary
  - Polish case: Assets or enterprise? Buying and selling businesses

## French case

- French listed group (ABC)
  
- Acquires foreign group (DEF)
  - DEF owns a prominent brand
  
- Some time after acquisition, ABC decides to rebrand its operations on the French market into using the DEF brand

## French case (cont'd)

### — Rebranding

- ABC France bears some rebranding costs
- License agreement signed between ABC France and DEF Foreign Co
  - Broadly labelled brand license agreement but includes
    - Right to use the brand, +
    - Access to DEF Foreign Co marketing expertise & know-how , +
    - Corresponding advice provided by DEF Foreign Co
  - ABC France pays a 1.5% royalty to DEF Foreign Co

## French case (cont'd)

- Brand license agreement with very similar terms used by DEF Foreign Co with other parties
  - Related
  - Fully unrelated (a few)
  - “Practically” unrelated (minority stake)
  
- A few existed before rebranding occurred in France, significantly more in the following years

## French case (cont'd)

- Royalty rate was determined using a model developed by the group
  - Based on profit split
  - Assesses additional value the DEF brand brings to the licensee
  - Splits this value according to a multi-criteria analysis
  
- CUP method used as a confirming method (using BLA agreements signed with a few third parties)
  
- Model implemented both for transactions with related parties and for negotiations with unrelated parties
  
- Model shows that using the DEF brand clearly adds value to ABC France

## French case (cont'd)

### — Tax audit in France

- For the years following rebranding
- The rebranding year itself is not covered (statute of limitation)

### — First approach of the FTA

- Model recognised as “valid” in principle, but...
  - Royalty rate is challenged
    - Parameters of the multi-criteria analysis are challenged
    - Use of the (so-called “famous”) “Rule of Thumb”
    - CUP is rejected (non comparable situations, non comparable markets...)
- ⇒ Royalty rate should be about a tenth of what was charged
- ⇒ Very significant profit reassessment

## French case (cont'd)

— Company has quite strong arguments to challenge to position of the FTA

- Notice of reassessment, written answer of the taxpayer, FTA's answer to the company's comments...
- Discussions with FTA at various hierarchical level

— The FTA acknowledges its first approach is invalid

- Mistakes in understanding how the multi-criteria model is built
- No true validity of a mere “rule of thumb”
- Additional arguments of the taxpayer

— But...

## French case (cont'd)

### — Second approach of the FTA

- The DEF brand has no value in France
  - Complex attempts to demonstrate so with economic analyses, mostly relying on hindsight
- Besides, ABC France has “economic ownership” of the DEF brand on the French market
- So...
- Validity of paying a royalty is challenged in principle!

### — Second round of discussions

- New notice of reassessment, new written answer of the taxpayer, new FTA’s answer to the taxpayer’s comments, new meetings with FTA at various hierarchical levels

## French case (cont'd)

— The taxpayer has as strong counter-arguments as before

- Licensee's net margin boomed since rebranding occurred
- Gained market share
- High level of marketing substance in DEF ForeignCo (hundreds of people, hundreds of € millions of costs...)

— But...

## French case (cont'd)

### — Sequels...

- Original case brought to competent authorities under EU arbitration convention (pre-arbitration phase is now over)
- More recent years were reassessed with same (second) approach
  - Another significant profit reassessment
- DEF was transferred between related parties in same Foreign country
  - FTA claims a share of capital gain is taxable in France because ABC France has economic ownership on the French market
  - **Yet another (even more) significant profit reassessment**

## French case (cont'd)

### — More sequels...

- 2010: Case brought to National Direct Taxes Commission
- Commission rules (position not binding the FTA) that FTA's case is not substantiated with enough evidence and that the tax reassessment is not grounded

### — But...

- FTA keeps maintaining their position...

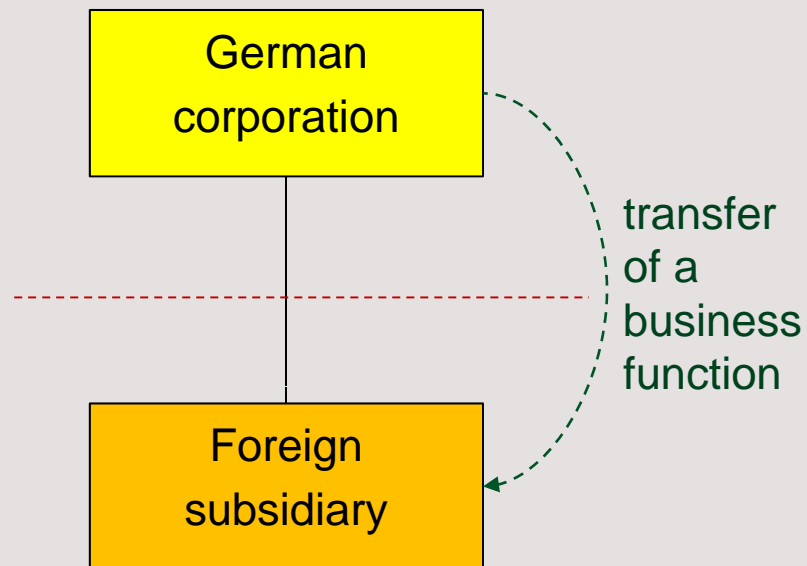
## French case (cont'd)

### — What to keep in mind (so far)?

- IP is high on FTA's radar screen
- Highly complex analysis capabilities at their level, but
- Self-inconsistency does not seem to frighten them
- Beware what information you make public!
  - Press articles, annual reports, etc
  - Everything you say may be used against you...
- Economic ownership: a new nirvana?
- The battle over marketing costs...

## German case

### Facts of the example



- Cross-border transfer of a business function, including chances and risks relating to the assets and “other benefits”
- Business function = transfer package
- Transfer also to be considered if carried out in steps, i.e. over up to 5 years
- Transfer would be deemed if a duplication of function takes place and the function in Germany is reduced during a period of 5 years

## German case (cont'd)

### Regulations applicable

- An income adjustment applies if no appropriate transfer price has been agreed (Sec. 1 Para. 1 German Foreign Tax Act).
- The valuation of the transfer package has to include goodwill (valuation based on future net profits and including market advantages of the acquiring entity).
- If the standard transfer pricing methods cannot be used, a “hypothetical arm's-length price” has to be determined which requires a comprehensive analysis. This includes the calculation of a “settlement margin” as the margin between the minimum price for the transferor and the maximum price for the recipient, assuming full information and adequate interest rates. If the most likely price cannot be determined, the medium value has to be applied.
- A one-time price adjustment may apply in the following 10 years, if no price adjustment clause has been agreed and the new transfer price is outside the original settlement margin.

## German case (cont'd)

### Alternative solutions

— Exemptions apply if:

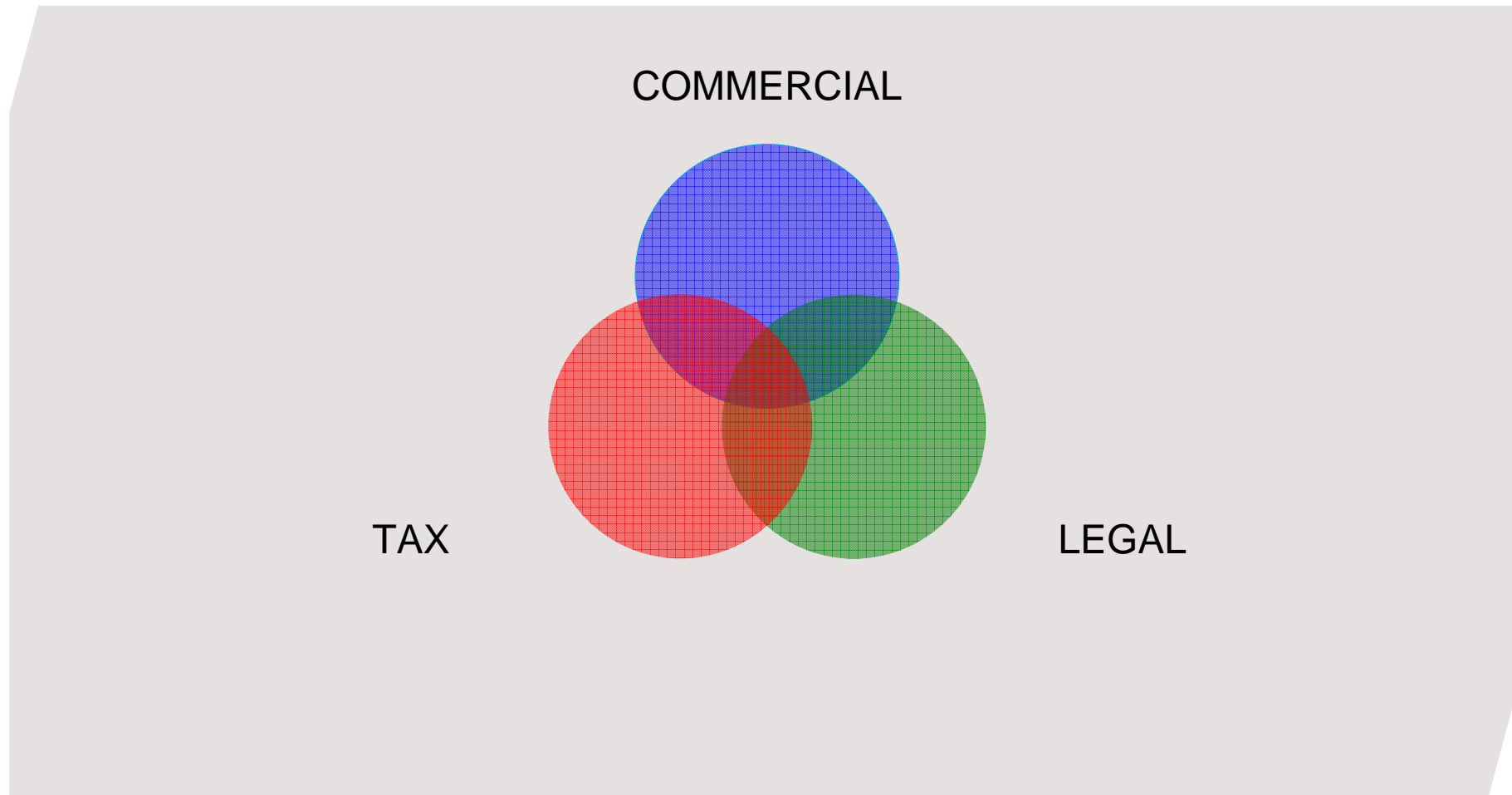
- Only single assets are transferred or leased
- Only services are provided
- Transaction is not qualified as a transfer of a business function by a third party
- Only staff is transferred (e.g. secondment, no function transferred)
- The function is only rendered from the receiving entity to the transferring entity and the remuneration is based on the cost-plus method
- ! **The intangible assets have a value of less than 25% of the total value of all assets transferred (individually valued)**
- ! **A material intangible asset being transferred can be clearly distinguished and is exactly described (evaluation on a single-asset-basis, valuation includes future projections/IDW S 5, administrative guidelines issued on 13 October 2010)**

— Proper documentation is needed for justifying the application of an exemption

## UK case

- UK FTSE listed group
- Food manufacturing
- Operational hubs in UK, US and Belgium
- Highly acquisitive
- Organic expansion over a number of years has given rise to substantial ‘pockets’ of locally owned Intellectual Property (IP)
- Concern over:
  - Inefficient tax management
  - Lack of transparency in IP control and protection
  - Parochial commercial structure

## Stakeholders



## Key issues

- Cash and tax costs of establishing new IP structure vs. long term benefits
- External market perception of any asset off-shoring
- Brand protection
- Flexible model to allow for expansion, new market penetration and different classes of intangibles
- Internal territorial clashes

## Stagegate process

- Determine preferred operational structure (IP Holding Company 'IPHC')
- Identify existing / ongoing IP and associated legal and economic ownership
- Determine most tax efficient method of moving existing IP to IPHC
- Establish operational controls to allocate future IP to IPHC

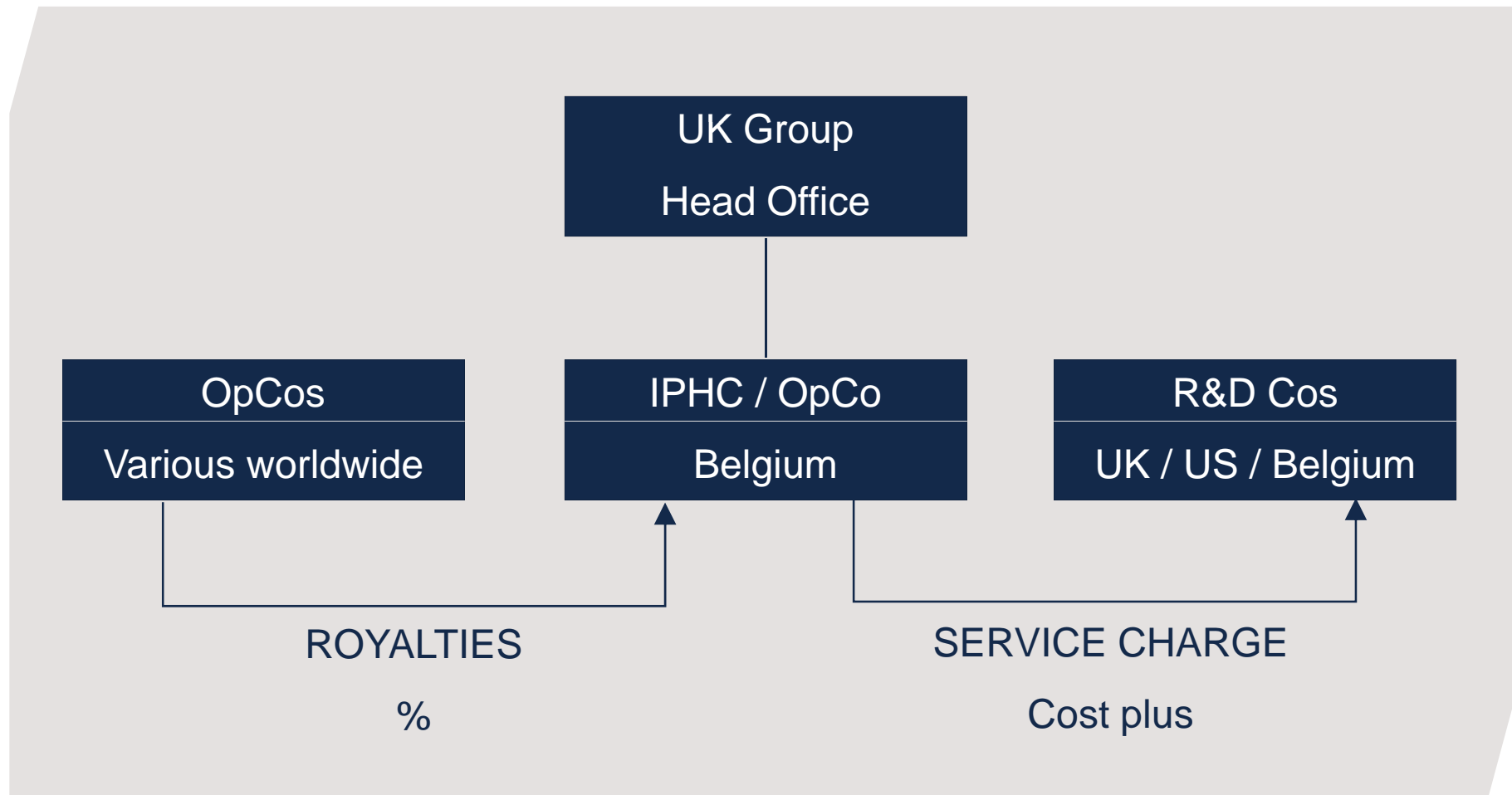
## Preferred IPHC location

- Corporate tax rate?
- Tax deduction for IP purchase/transfer?
- Funding structures?
- Existing group operating/capital losses?
- WHT rate on royalties?
- Enhanced tax deductions on R&D costs?
- Availability for deductions on sub-contracted R&D?
- Anti-avoidance legislation?
- Legal protection for IP?
- APAs/ tax rulings available?

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## Structure – Significant ongoing losses in Belgium



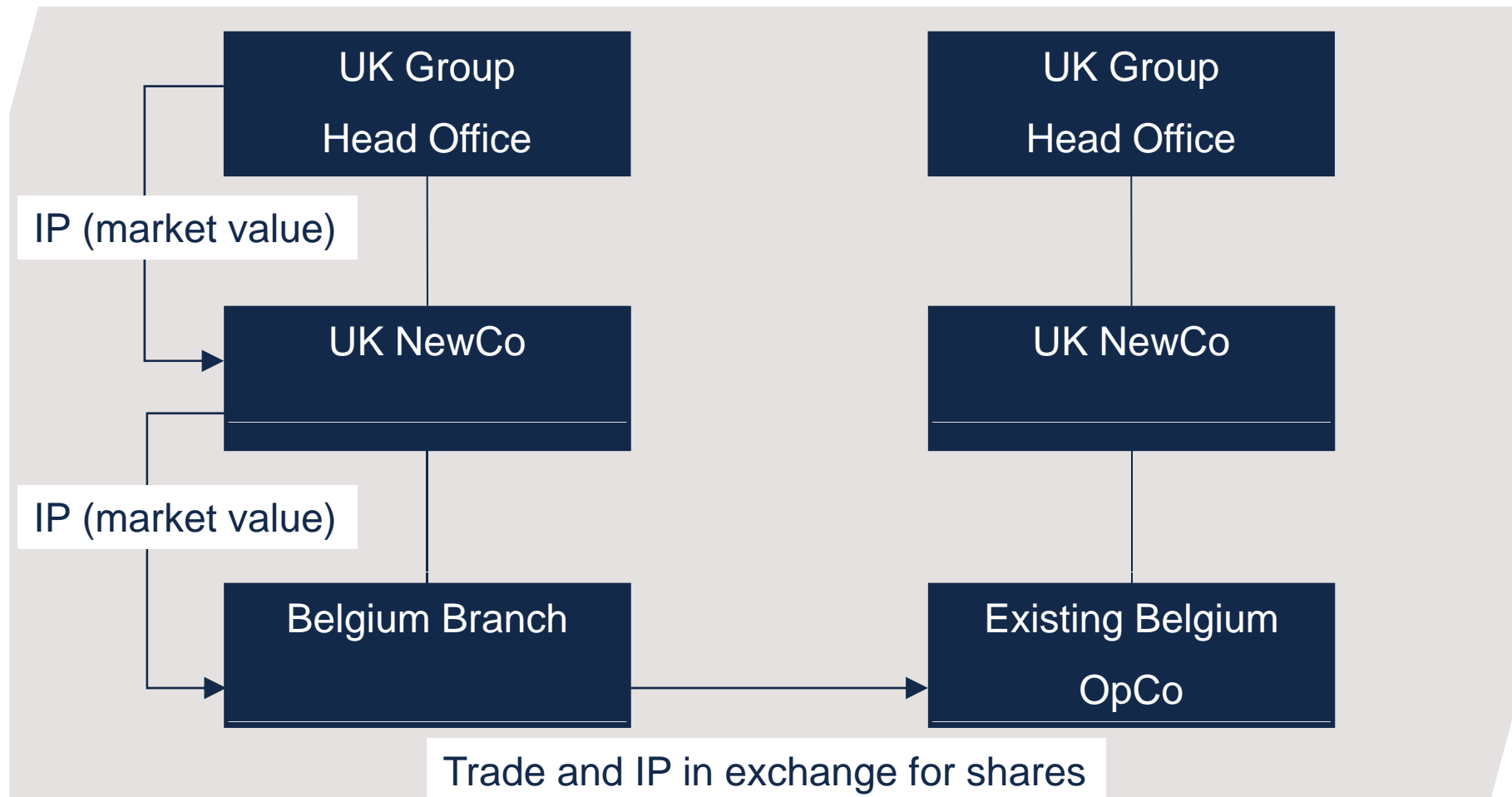
## Structure

- UK IP contributed to existing Belgian subsidiary at open market value in exchange for equity
- US IP allowed to 'wither on the vine'
- New IP created within Belgian IPHC

## Benefits

- Tax efficient with royalty income offset against:
  - Enduring tax losses
  - Notional interest deduction
  - IP amortisation expense allocated over the useful economic life of the asset
- No Belgian capital tax on contribution of IP
- Exit charge from UK deferred by use of branch incorporation given substantive operations in Belgium
- Extensive Belgian tax treaty network for WHT purposes

## Structure – Moving IP out of UK



## Issues

- UK CFC position to be managed
- Prevailing Belgian CT rate may negate tax benefits in the event that royalties are not covered by losses or deductions
- Legal protection of IP in Belgium potentially a risk factor

## General practical considerations

- 2010 version of OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations approved in July 2010, incorporating new Chapter IX relating to ‘Transfer Pricing Aspects of Business Restructurings’
- Continuing work by OECD on ‘Transfer Pricing Aspects of Intangibles’, ongoing consultation with further developments likely in 2012
- Expanding APA programme in many countries, potential for underwriting any tax exercise

## Corporate taxation of IP, royalties and R&D in Hungary

### — Summary of facts

- Progressive CIT system: 10% and 19% brackets (below and above tax base of HUF 500 million, approx. EUR 1.8 million)
- 50% of gross royalty income exempt (capped at 50% of pre-tax profits), thus effective 5% or even less CIT rate may be achieved on royalty income (depending also on the degree of royalty-related and other expenses). No local business tax applies on income from royalties
- Generally no WHT on outbound royalty, interest and dividends payments to non-individuals (except 30% WHT on royalties, interest and services fees paid to non-treaty countries – likely abolished from 1 January 2011)

## Corporate taxation of IP, royalties and R&D in Hungary (cont'd)

### — Summary of facts

- “Royalty” – definition includes consideration received for transferring the economic right related to patents, know-how and copyright
- Generous R&D incentives:
  - Normally, 200% of direct R&D costs are tax deductible
  - In addition, a tax credit equal to 10% of wage costs with regard to R&D activities is available (special conditions and limitations apply, though)
- Unlimited tax loss carry-forward

## Corporate taxation of IP, royalties and R&D in Hungary (cont'd)

### — Pros:

- Due to the aforementioned system, Hungary is a suitable jurisdiction for setting up R&D centers
- Hungary is also a suitable location for locating intra-group licensing entities: by careful (yet easy) structuring an effective CIT rate of 5% may be achieved, the resulting profits can be extracted tax free (no WHT on dividends if paid to non-individuals, dividends income usually tax free at the level of parent)

### — Cons:

- Rapidly changing tax laws, unforeseen changes, uncertain political climate
- Yet: wide consensus about maintaining royalty and R&D incentives

## Assets or enterprise? Buying and selling businesses in Poland

Facts: Company A sells its business to Company B

### Subject of transaction

- Part of enterprise?  
OR
- Assets?

### Agreed price

“50 mln EUR plus VAT  
if applicable”

### Tax ruling

“If debts are not  
transferred  
the transaction  
is a sale of assets”

— **Result: EUR 11m VAT and no transactional tax (EUR 1m)**

## Assets or enterprise? Buying and selling businesses in Poland (cont'd)

### Applicable Regulations

#### — EU Law

- Council Directive 2006/112/EC on the common system of value added tax (**article 19**)

#### — Polish Law

- Civil Code (**art. 55(1)**)
- Tax Ordinance Act (**art. 14b § 1 and 6**)
- VAT Act (**art. 2.6, art. 2.27e, art. 6.1**)
- Act on Tax on Acts in Civil Law (**art. 2.4**)
- Corporate Income Tax Act (**art. 4a.4**)

## Assets or enterprise? Buying and selling businesses in Poland (cont'd)

### — Solution

Consider  
Debts

- If no debts are transferred – from the Polish tax perspective the transaction can be treated as a sale of assets

Obtain  
Tax  
Ruling

- No fiscal or criminal sanctions
- No penalty interest, and sometimes...even
- No taxation

Check  
Price  
Clause

- If VAT is payable – cash flow issue but full recovery of tax
- If transactional tax is payable – no recovery of tax