Podcast transcript

The role of substance in transfer pricing

Podcast with Mark Horowitz, Principal of Transfer Pricing Dispute Resolution Services at KPMG in the US*.

Musical intro

Announcer:

Hello and welcome to another episode of *'Future of Tax'*, the KPMG podcast series for Tax leaders. In today's episode I'm joined by Mark Horowitz, Principal of Transfer Pricing Dispute Resolution Services at KPMG in the US.

Mark, thanks for taking the time to join me today and apologies that we're having to speak today over the phone.

Mark:

No worries, I understand.

Announcer:

Mark, as you know in this series, we've been talking with tax leaders from across KPMG about various topics within the themes of geopolitics, digitalization and changing business models. In today's episode I wanted to discuss with you some of the recent developments in the concept of substance and its role in transfer pricing. But to start that conversation I wonder if you could outline exactly what the concept of substance is and how it's been impacted by COVID-19?

Mark:

Yeah, so substance in this context means real business operations which is usually interpreted to mean people, employees, boots on the ground, or some other real business function as opposed to, for example just a mailbox or a registered address with no people, employees, or operations.

The concept of substance and its role in transfer pricing is a topic that's having a significant impact on companies' business models and how they need to evolve them to be successful. And we've seen that in a number of different ways and from a number of different perspectives.

The importance is that – for multinational enterprises, is that tax authorities have a renewed interest in substance in the past few years. For example, the OECD recently implemented new global standards for no- or low-tax jurisdictions that require, quote "substantial activities" in order for a tax regime to not be considered a harmful tax practice. And the objective of this renewed scrutiny from the OECD and global tax authorities is to ensure that companies are not shifting profits to no- or low-tax jurisdictions that don't contain much real economic activity within the view of the tax authorities.

The COVID-19 – and the recent disruptions due to it – have brought about new substance issues. For example, many companies have found that some of their employees are temporarily unable to work in the jurisdiction where they normally perform their functions.

For instance, this could be the case where there is travel bans or guidelines that cause employees to temporarily remain in a jurisdiction other than their home country[/jurisdiction] or their residence country[/jurisdiction], or where employees ordinarily live in one jurisdiction and commute to another but are unable to do so because of – because of COVID-19. And these so-called dislocated employees can create a lot of different tax issues at the company level for multinational enterprise taxpayers, and at the individual level such as tax residency and PE issues.

Several jurisdictions have released guidance addressing some of these tax issues and the OECD has as well. However, as yet we're not aware of any jurisdiction or the OECD releasing guidance on how the activities of these dislocated employees will be considered for transfer pricing purposes and that is when applying substance, DEMPE, control of risk concepts, that's – that's an open question.

So, for example, the question is; is substance or DEMPE going to be affected by employees who are dislocated for 6 months or a year when hundreds of millions of people across the world have begun working remotely?

And another question for the OECD and other tax policy makers is; should it have an effect? How will the long-term changes in remote working patterns affect how we think about substance and DEMPE concepts when we have such a large number of people working remotely?

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And then finally, COVID-19 is leading to significant changes in business models and supply chains. Many companies' business models were already digitizing and the COVID-19 crisis, in addition to remote work, it's continued to accelerate the pace of digitalization, which can lead to changes and large questions – fundamental questions – in terms of what is the basis of substance? What really is substance? What is its role in the international tax system and in transfer pricing? And because of the increased scrutiny on substance and companies changing business models, and because of the COVID-19 crisis, most – many if not most companies are revisiting their business models to ensure that substance and their transfer pricing policies align and that they can deal with some of the issues that have arisen based on – you know, tax authority policies and COVID-19.

Announcer:

Thanks Mark. So, beyond COVID-19, can you outline some of the other recent developments around the concept of substance that our listeners should be aware of?

Mark:

One of the biggest developments over the past few years around substance and the concept to substance, is the concept of control over DEMPE functions. That is the Development, Enhancement, Maintenance, Protection and Exploitation of Intangible Property, abbreviated DEMPE.

This has become a really important issue in transfer pricing and international tax and it's impacting taxpayers in both direct and indirect ways. The separate but similar concepts which are set forth in the – in the reports around BEPS Action Items 8 through 10, of, quote "control over risk" or "capacity to take risk" will also continue to affect how we view contractual re-shifting, restructurings of risks and functions, and other planning. And BEPS 2.0, as it's known, may introduce even more evolved or different substance concepts and associated consequences.

Announcer:

Mark, you mentioned the concept of control over DEMPE functions, BEPS actions 8 through 10 and the evolution of BEPS 2.0; have you seen the impact of these on taxpayers yet, for example in examinations?

Mark:

Yes. We've absolutely begun to see the impact of these new concepts on taxpayers in the examination context and elsewhere. Because these are OECD developments and evolved changes to the OECD transfer pricing guidelines and the interpretations or commentary with respect to the OECD transfer pricing guidelines – you know, including explicit changes to the guidelines. In any country[/jurisdiction], which is a lot of countries, which explicitly or implicitly incorporate the OECD guidelines or whose laws or transfer pricing laws and tax laws are based on the guidelines, or which generally have relied on OECD principles to interpret their own domestic law, these concepts play a really active part in a transfer pricing examination because they're – they're either – either implicitly or explicitly incorporated into the law that's being applied.

Especially in Europe, we've started seeing a rise in audits. Examples would be Sweden, Denmark, Germany, but really across Western Europe, a rise in audits specifically focused on DEMPE or control of risk or substance concepts. You know, there always were cases where that was maybe the subtext, but we're seeing cases where that is the primary, and explicitly, the issue.

Most of the cases so far have involved restructurings, planning – corporate planning and restructuring or acquisitions, as opposed to sort of more bread and butter transfer pricing structures. You know – in addition to active exams, we've also seen a lot of countries have started to incorporate these concepts in specific anti-abuse rules.

A couple of examples would be the U.K. diverted profits tax, the DPT, and the Australian model. These incorporate similar substance concepts to those set forth in the OECD transfer pricing guidelines.

In addition to developments in Europe and elsewhere, what's very interesting to me – I'm a U.S. practitioner – is that we've actually begun to see the IRS. And when I say IRS, I'm including both exam teams, the transfer pricing practice, which works with exam teams on transfer pricing issues, and the Advanced Pricing and Mutual Agreement Program, APMA, begin to make arguments or at least consider these issues as part of their cases. Historically, contractual terms in the U.S. have really determined substance and intercompany transaction and really defined what the IRS will – you know what arguments the IRS will make in terms of transfer pricing examination.

But the IRS has increasingly been inquiring into substance, into DEMPE functions, for example, undertaken with respect to intercompany transactions. And what's especially interesting is that this is despite the fact that the U.S. regulations, the Section 482 regulations have not changed.

So as a technical matter, any changes to the OECD transfer pricing guidelines or commentary or non-U.S. transfer pricing law or principles, technically should not affect either the interpretation or the application of Section 482 and the 482 regulations, but these concepts are beginning to see their way into IRS examinations despite the fact that the regulations haven't changed.

Another important factor to remember is that businesses are rapidly digitizing and as a result, the people performing DEMPE functions, the people that you're relying on for substance within a multinational enterprise are much more mobile, right? And companies are going to be hiring employees that are not necessarily centered around a physical location. And we're continuing to see this have a big impact on taxpayers and taxpayers having – you know, either a difficult time with this or certainly spending a lot of time considering what to do with respect to these issues.

For example, let's just consider if your research and development director for a particular company lives in Germany but then moves to the U.K. and works in the U.K. remotely, does that

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mean that the company's substance related to research and development has moved to the U.K. as well? And that there needs to be a significant modification to the transfer pricing between the U.K. and Germany and other jurisdictions entities that are involved in the research and development for that particular company, just because of one employee working remotely or moving their tax residence?

These are the sort of questions that our clients are trying to resolve right now, in addition to the tax authorities' and they're pretty difficult questions.

Announcer:

And how would you say taxpayers are reacting to these developments?

Mark:

In my experience, most taxpayers are – are trying to address these issues in a thoughtful and principled way within the confines of their existing organizational structure and their business needs. For example, they're adding or increasing substance to the extent possible to comply with the revised and new rules on substance that have evolved over the past 5 plus years.

And they're also improving their internal governance practices, their policies, transfer pricing and otherwise, to make the substance that they do have in particular entities and particular jurisdictions clearer, and to document the activities that are being conducted in the various jurisdictions where they operate.

Because tax authorities are putting more focus on substance issues that means that companies have to be ready to substantiate the substance. Any changes as well to a company's tax or transfer pricing structure has to take substance concepts into account. It's just something that needs to be looked at as part of any restructuring or planning activity.

And one thing that is increasingly the case, but that not every company has fully looked at, is the digitalization of the economy and the digital activities of each company, may require new substance concepts to be taken into account. So, to answer your question, taxpayers are definitely reacting and taking substance concepts into account.

I'm not sure that all taxpayers have done everything they can, in some cases they're doing what they perceive to be the minimum required and I think a lot of taxpayers also need to react a little quicker to the digitalization of their – of their companies' business models and how distributed their employees actually are throughout the world.

Time will really tell, I think, whether companies have done enough with respect to substance and how high the bar is going to be set factually in terms of interpreting and practically implementing these new rules in – you know – in both the planning context and in later tax authority audits or examinations of companies.

I know that some companies, even though there have been a lot of developments in the past 5 years, they're waiting to see the outcome of the BEPS 2.0 initiatives and the potential next wave, the evolution, if you will, of substance essentially and any potential modifications or impacts of BEPS 2.0 on substance requirements.

Announcer:

So, Mark do you see this concept of substance changing in the coming years?

Mark:

Absolutely. The next wave of international tax reform is, of course, connected to the various efforts to address the digitalization of the economy, which is commonly known as BEPS 2.0. I think that – you know – what companies have to come to terms with is that we're in the very early stages of the digital revolution, even though it's been occurring for years.

We are in the early stages of digitalization and the disruption that that's going to cause, and there's going to be a continued shift, especially in developed economies, but throughout the world, towards digitalization. And that substance concepts will become increasingly important potentially as a component of a traditional transfer pricing analysis partly because the traditional metrics of value and business activity in a jurisdiction like hard assets or headcount that are physically in a jurisdiction will – are likely going to become less and less relevant as digitalization becomes more dominant.

On the other hand, we have the work on Pillar One, related to BEPS 2.0. We've seen new NEXUS concepts emerge, and these aren't necessarily clearly rooted in our current notion of substance, which is associated with physical presence of individuals. For example, the unified approach under Pillar One suggests that market jurisdictions may attract some type of return under transfer pricing principles if a company has beyond a minimum threshold of sales in a particular jurisdiction, and there's no employees or presence required. So that's an evolution of substance in a way related to a particular economic market.

And the unified approaches amount, "A", proposes allocating a portion of profits to market jurisdictions. So even though taxpayers may not have physical presence or employees in these particular jurisdictions, which is really the way we've historically thought about substance, they have an economic market, they have in-country[/jurisdiction] users or they somehow earn sales in these jurisdictions.

And – so that said, there's not yet clear principles underlying this work and there's not certainly a consensus or agreement on this framework. So, currently it's really unclear how substance concepts and physical presence concepts are going to fit into the BEPS 2.0 framework.

At the end of the day, is the OECD essentially going to say that a company has substance in some jurisdictions regardless of physical presence and in-country[/jurisdiction] functions? Are we going to evolve from substance? Are we going to say that substance – the concept of substance or the traditional concept of substance, I should say, doesn't really matter after digitalization and that this expansion NEXUS and taxation rights is more of a political question such as a deemed or minimum

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taxation and anti-abuse regime that's just totally separate from substance concepts? Currently unclear.

Similarly, under Pillar Two, a key question is whether the minimum tax rules would apply to low-taxed income in jurisdictions that pass substance thresholds. There hasn't been any agreement on that. And so, again, the role of substance in the BEPS 2.0 framework is really in flux right now.

So if you have a company with primarily digital assets, which have developed via virtual teams that are dispersed over a number of countries and the services or the products, which are created or sold throughout the world and the company has a handful, right, two, three, five people of high level management in country[/jurisdiction] X, but then the digital assets ownership is in country[/jurisdiction] Y, where is the income going to be taxed? Right. That's kind of a difficult question that policymakers are trying to think about.

And what if you changed the location of the asset ownership or of the high-level management? Should the income shift with this change? In some ways as digitalization increases the current DEMPE and substance concepts, really, may be a double-edged sword that can – that can cut against both taxpayers and tax authorities.

And the current substance concepts really may ultimately not be important or necessary to finding NEXUS or determining tax jurisdiction because ultimately BEPS 2.0 concepts may apply different principles such as market presence, which could make the current concepts of substance less relevant. Again, we really have to wait and see how – you know – see how these policies and projects evolve.

Announcer:

So Mark, to conclude our conversation what advice you could offer tax leaders dealing with these developments in the concept of substance?

Mark:

It seems very likely that current substance concepts, DEMPE is the primary example, may need to be simply a bridge to a different substance standard, or as I mentioned, a system where substance concepts are less relevant or important to determining taxing jurisdiction than allocating income.

And taxpayers really have to follow BEPS 2.0 developments closely in the coming years because company structures are really going to have to evolve based on how BEPS 2.0 turns out and how it's implemented. So, one thing's clear, the days when you could allocate significant amounts of income to low-tax jurisdictions without any substance are generally over.

I think the question moving forward is going to be whether taxpayers will be able to allocate income to low- or no-tax jurisdictions at all, given BEPS 2.0 and the evolution and proliferation of anti-abuse taxes. And the question is going to be, even if there is substance in a jurisdiction, whether there's going to be any incremental benefit to allocate an income to a low- or no-tax jurisdiction.

So, it'll be very interesting to see in the coming – coming couple of years how BEPS 2.0 evolves and how it interacts with substance concepts.

Announcer:

Great advice Mark thanks. And thanks again for taking the time to join us today, you've given our listeners a lot to think about.

Join us again next time where we take a look at another trending topic within geopolitics, digitization or changing business models. And please feel free to email us with any questions or suggestions for future topics you would like to hear more about at tax@kpmg.com.

Thanks for listening!

Musical exit

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