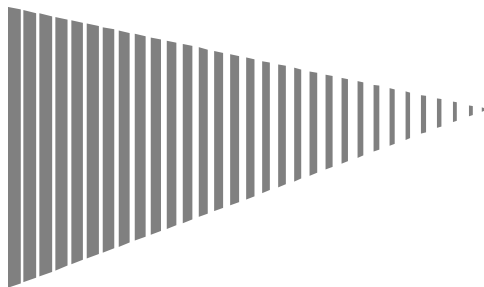


Structuring your IP deals: Looking into a comprehensive approach

Tax structuring and transfer pricing

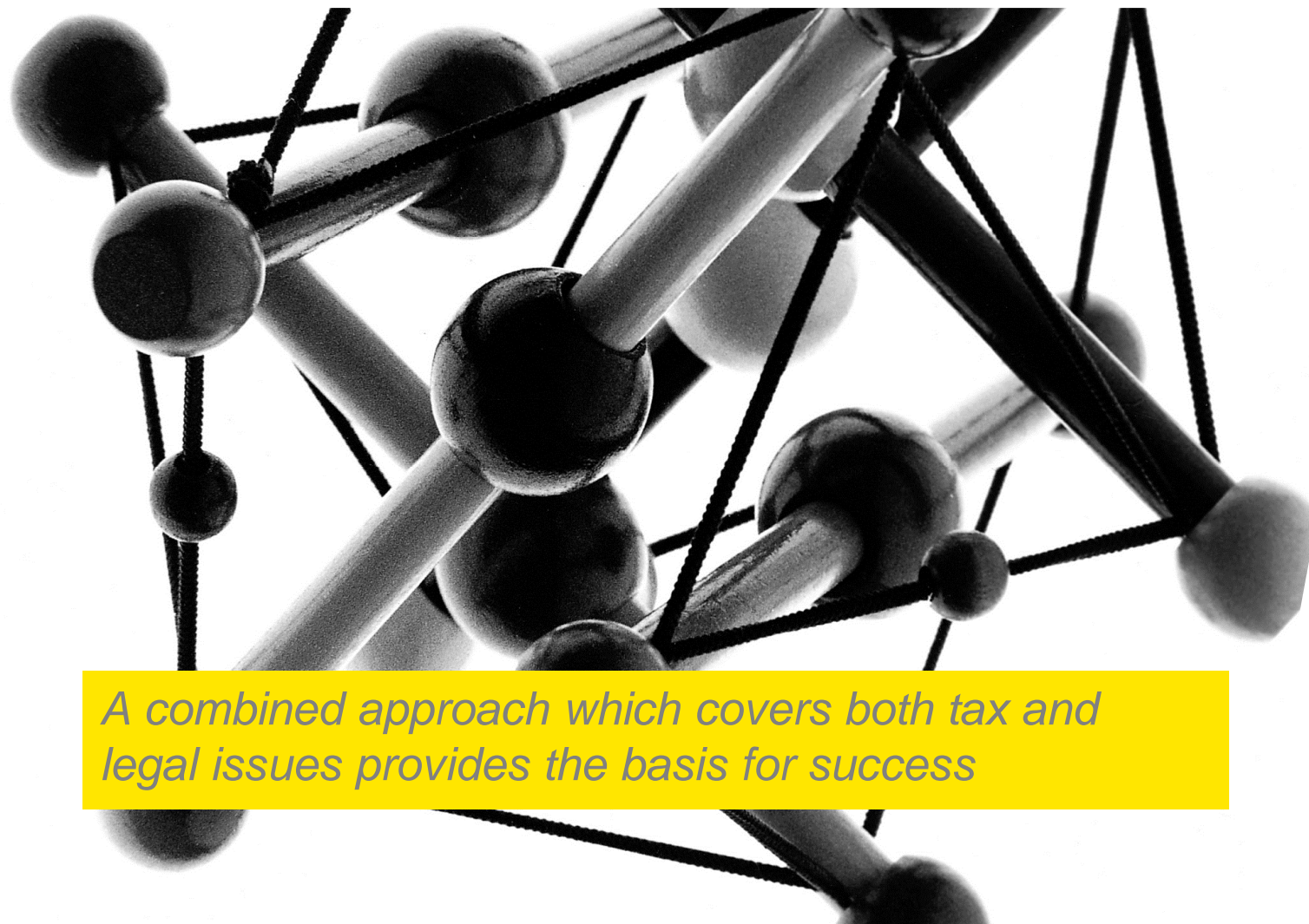
5 December 2014



EY 安永

Building a better
working world

Tax planning opportunities



A combined approach which covers both tax and legal issues provides the basis for success

Tax planning opportunities (Cont'd)

Basic principle of IP tax planning

IP company/licensor in low tax jurisdiction to gain:

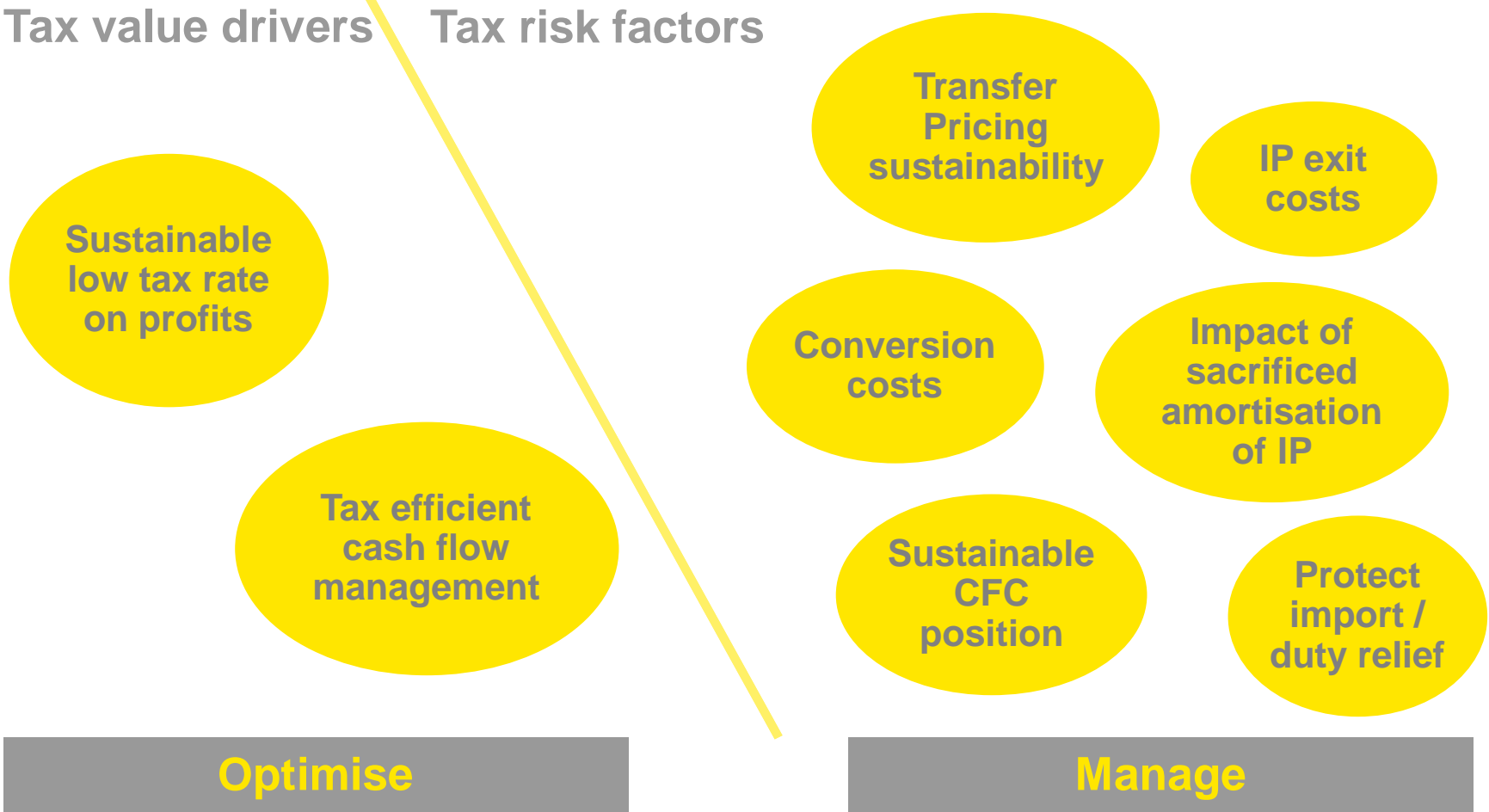
- low taxable royalty income; and
- better amortization deduction

Possible further benefits for group of companies

Licensee in high tax jurisdiction:

- Royalty payments deductible against higher tax rates
 - Additional tax benefit for the group

Tax optimization – tax drivers and risks



Hong Kong as Asia's flourishing IP hub

Hong Kong is an international platform for IP trading mainly due to:

- ▶ Favorable geographical location – proximity to the Chinese Mainland and the wider regional market
- ▶ Well-established legal system and stable economic environment
- ▶ Strong corporate governance with robust IP protection
- ▶ Presence of a pool of IP specialists able to provide comprehensive services to IP-related industries
- ▶ Availability of IP financing resources
- ▶ Cost effectiveness, e.g. hiring, rental, taxes

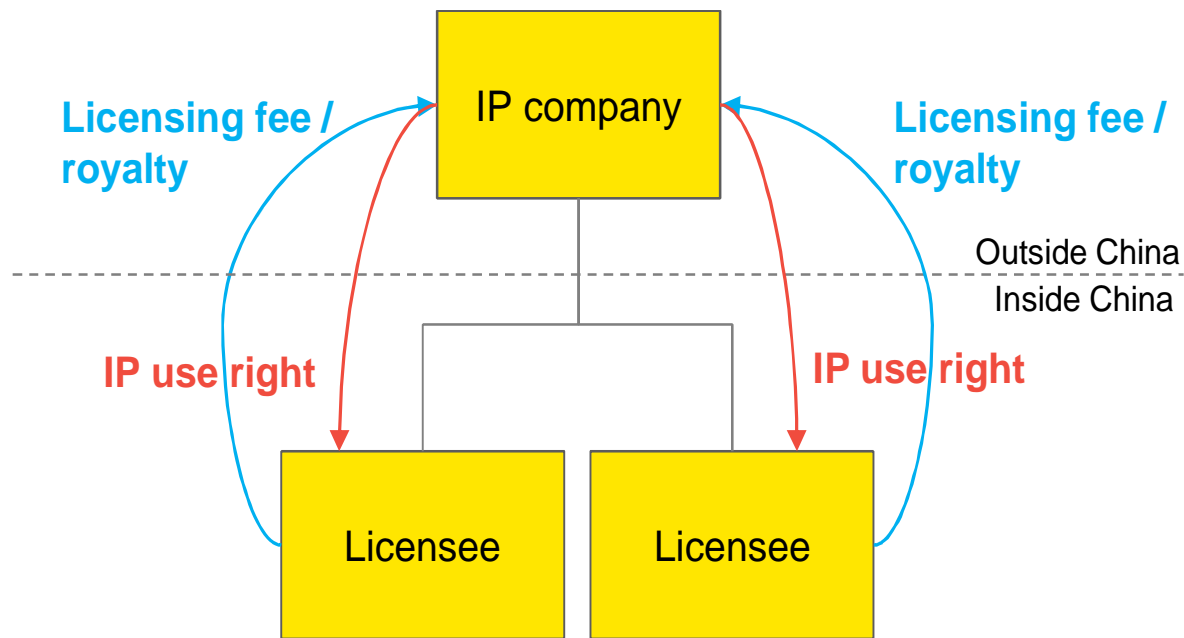
Sourced from: HKTDC research on 12 March 2013

Hong Kong as Asia's flourishing IP hub (Cont'd)

From tax and legal perspectives:

- ▶ Profit tax rate at 16.5%
- ▶ No capital gains tax
- ▶ No withholding tax on dividend and interest
- ▶ Only profits arise in or are derived from Hong Kong are taxable
- ▶ Royalty income received by persons not carrying on business in Hong Kong is only subject to profit tax when:
 - ▶ IP rights are used in Hong Kong or the manufacturing or sale of goods in relation to the IP rights takes place in Hong Kong; or when the payer of royalty can claim tax deductions
- ▶ Possible reduction in withholding tax on royalty may be obtained under Hong Kong's tax treaties network
 - ▶ Under the Mainland China-Hong Kong tax treaty, a preferential WHT rate of 7% (vs. 10% standard rate) could be granted provided that the HK licensor is qualified as the "beneficial owner" of royalty income
- ▶ No foreign currency control in Hong Kong
- ▶ Cost effectiveness of maintaining a Hong Kong company:
 - ▶ Ease to set up a Hong Kong company and bank accounts
 - ▶ Low maintenance costs for filing annual returns and tax returns, preparing audited accounts, etc.

Latest IP considerations in China



China tax implications

- 10% WHT (or lower tax treaty rates)
- 6% VAT under the VAT reform and relevant local levies
- Qualified VAT exemption for income derived from operation of technology transfers, technology development and the related technology consultation and technology services

- ▶ Transfer pricing and tax concerns
 - ▶ Any tax planning flavor? Considerations to optimize a group's tax position?
 - ▶ Recognition and valuation of IP licensing transactions
 - ▶ Chinese licensee's participation in R&D activities – potential risk to be challenged for creation and licensing of IPs?
 - ▶ Reasonableness of royalty charge?
 - ▶ Difficulty in remitting royalty out of China?

Note: "China = 'mainland China'"

Licensing IP to China – transfer pricing challenges

- ▶ Valuation of IP and determination of appropriate royalty rate
- ▶ Legal ownership vs. economic control of intangibles
- ▶ Local contribution
 - ▶ Without local contribution, would global technologies and brands be able to generate value within a short time in China?
 - ▶ Development and improvement of technology and specific knowledge
 - ▶ Market penetration and development and improvement of brands/product names
 - ▶ Client relationship maintenance
 - ▶ Others
- ▶ High and new technology enterprise (HNTE)
 - ▶ Legal ownership of core IP
 - ▶ Practically difficult for HNTE to be eligible to enjoy preferential tax treatment when making outbound royalty payments
 - ▶ Some companies are considering to obtain certification from international certification organizations so as to maintain the qualification of HNTE

Licensing IP to China – recent China tax developments

- ▶ The State Administration of Taxation (“SAT”) has recently released an internal notification to urge local tax authorities at all levels to carry out extensive tax investigations on substantial amount of service fee and royalty payment made by domestic enterprises to their overseas related parties from year 2004 to 2013.
 - ▶ Emphasize on business purposes and commercial substance of the payments
 - ▶ Investigations shall be focused on the following royalty payments:
 - ▶ Royalties paid to entities located in tax havens
 - ▶ Royalties paid to overseas related parties that undertake no or little functions
 - ▶ Significant amount of royalties paid for IP to which the payer has made significant contribution
 - ▶ Significant amount of royalties paid for IP whose value has been impaired or inclined

Companies that are lacking a transfer pricing policy or other business justifications for their payments should take initiative to review their practice, identify potential tax risks and make proper rectifications.

OECD BEPS action plan achievements

Action 8 – Intangibles

- ▶ Final revisions have been made for Action Plan 8 regarding OECD Guidelines Chapter 1, 2, 6 involving intangibles:
 - ▶ Provides clear definition of intangibles
 - ▶ Provides guidelines for confirmation the existence of intangibles-related transactions
 - ▶ Provides additional guidelines for intangibles-related arm's length conditions
 - ▶ Provides guidelines for transfer pricing treatment of local market characteristics and multinational enterprise group synergy
 - ▶ Demonstrates the application outcome associated with relevant arm's length principles
 - ▶ Action Plan 8 would be finalized when the guidelines for Action Plan 9 and 10 are completed due to the consideration of the risks and capital
- ▶ On 16 September 2014, OECD issued an explanatory statement about the achievements:
 - ▶ The revised guideline will ensure that the economic return together with the economic activities performed should match with the value creation
 - ▶ Zero toleration on artificial shifting of profit to no or low tax jurisdictions
 - ▶ The action plan will be finalized in 2015

Possible mitigation of transfer pricing and tax risks

- ▶ To establish a robust pricing policy for IP licensing arrangement
 - ▶ Economic benefits
 - ▶ Pricing rationale – arm's length principle, functional and risk profile
 - ▶ Pricing consistency within the group
- ▶ To prepare supporting documentation for IP licensing arrangement, for example:
 - ▶ IP licensing agreements
 - ▶ Supporting documents on how IP is applied/developed, ownership of IP, estimation of expected benefits, R&D expenses, likelihood of replacement, functions undertaken and risks borne by the taxpayer and its related parties, etc.
- ▶ Remedies for adjustments to royalty charge
 - ▶ e.g. Mutual Agreement Procedures (MAP) for resolving tax disputes
- ▶ Restructuring the operation and transaction flows
- ▶ Alternatives to IP licensing arrangement
 - ▶ e.g. cost sharing arrangement but may be practically difficult

Maximize tax efficiency and mitigate potential transfer pricing risk

EY | Assurance | Tax | Transactions | Advisory

About EY

EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

© 2014 Ernst & Young Tax Services Ltd.

All Rights Reserved.

APAC no.03001350

ED None.

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax, or other professional advice. Please refer to your advisors for specific advice.

www.ey.com/china