

Case Study 2

International Taxation

2019 DIPCAT ISP
Bournemouth, UK





DIPCAT Case 2

Introduction to International Taxation

ISP – September 2019

Context

Governments rely on tax revenue to provide public services such as education, healthcare, defence, legal systems, and infrastructure for transportation. While we may not like paying taxes, where would we be without these much needed services?

The global and increasingly digital economies in which we do business compromises nations' tax bases. For the past decade, the spot light has been on many well-known multinationals and their ability to minimise their global tax obligations through aggressive planning and by exploiting differences in nation's tax legislation.

As tax revenue is the life-blood of nations, the international community has come together to combat such aggressive tax avoidance and strengthen their respective legal positions and their bilateral agreements. The G20 and the OECD reacted swiftly with the [Base Erosion and Profit Shifting](#) package which comprises 15 measures to tackle tax avoidance caused by BEPS. There are over 125 countries and jurisdictions now working together to monitor the implementation of the BEPS measures. The EU also continues to tackle tax avoidance and evasion issues through a number of directives and proposals. The Anti-Tax Avoidance Directive (ATAD) with its five measures came into force 1 January 2019 for all Member States.

The DIPCAT Project

We are developing a case study that highlights national and international tax issues of a MNE operating throughout Europe. The case features a leading manufacturer and retailer in eco-fashion. The fictitious Group has developed a technique by which their clothing is manufactured through 3D printing. The medium-term strategy of the Group is for their sales to be made directly in the homes of their customers through software download.

We suspect this fantasy Group is not far from reality. The Financial Transaction Tax proposed by the EU and emerging in national legislation is aimed at current and very real digital giants (i.e. Amazon, Google, Netflix, YouTube). The Common Consolidated Corporation Tax Base is another EU proposal responding to the relative ease of shifting profits to lower tax jurisdictions.

This case will give students an appreciation for the complexities MNEs, tax advisers and tax authorities face in the current international tax environment. We will consider national and supra-national frameworks that impact the European Group.

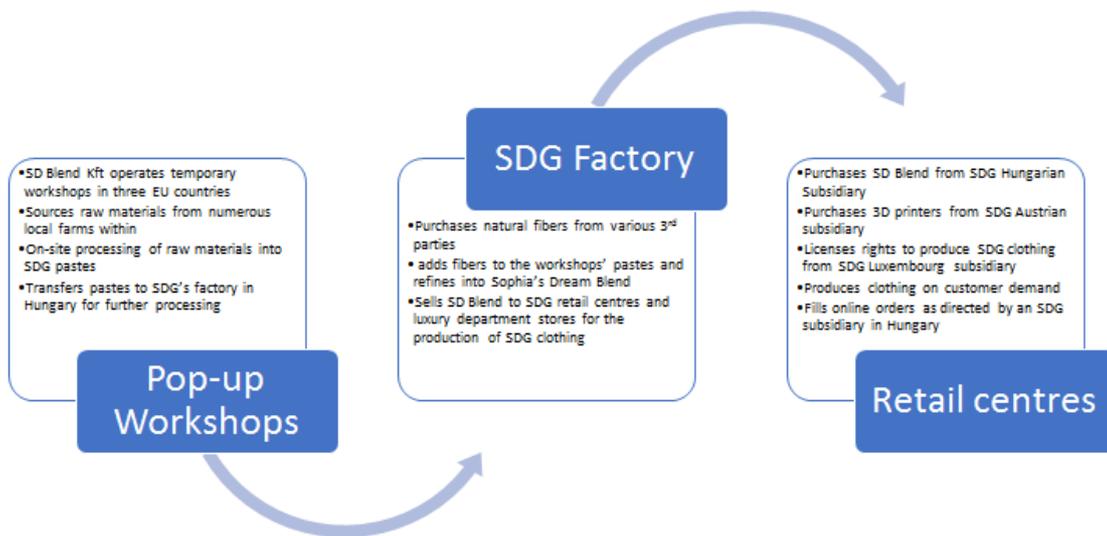
The case is being designed to cover a multitude of issues which, taken in its entirety, would necessitate a full semester's engagement. The elements that will be considered in DIPCAT's Intensive Study Programmes are narrowly focused and foundational. Students will enjoy three specific, team-oriented tasks. The finale will be a courtroom role-play between the Group's Tax Advisers and two nations' Tax Authorities!

DIPCAT Case 2 Sophia’s Dream Group Case Study ISP – September 2019

Sophia’s Dream Group (SDG) is the leading manufacturer and retailer in *eco-fashion* – sustainable and organic clothing. The clothes are currently available online and through luxury department stores in various countries.

SDG have developed a technique by which their clothing is manufactured through 3D printing, with the main ingredients for the raw printing material being tomato vines, tulips and deconstructed (up-cycled) natural fiber clothing.

The tomato vines and tulips are by-products of the crops and bulbs grown in Portugal, Greece and The Netherlands. They are initially processed (i.e. reduced to a paste) in seasonal, *pop-up workshops* within those countries. The pastes are then transported to a factory in Hungary where they are refined and blended with the deconstructed natural fibers to create the raw printing material suitable for 3D printing. The raw printing material (known as Sophia’s Dream Blends) is then sold and transported to the six *retail centres* on demand. The SDG supply chain is reflected in the diagram below.



The retail centres, owned by SDG, are where the clothing design pattern software and 3D printers that enable the production of the clothing are located. Customers can shop at the centres to purchase clothing which is produced by the 3D printers on demand. SDG also use *interactive holograms* projected in the retail centres to show customers what their clothes will look like.



SDG also place their 3D printers in a number of luxury stores in selected cities within the UK, France, Spain, Italy, Hungary and Germany. Prototypes of new clothing designs produced using SDG's technology are developed and displayed at *semi-annual fashion shows* in London, Paris, Madrid, Milan, Budapest and Berlin. The orders for the software patterns for these designs and the raw printing material placed by luxury retailers at these shows are substantial.

Clothing made to order is custom-fitted to each customer with the customer's precise measurements being digitally determined and recorded through Sophia's Dream Fit App. The App is available for use on a number of different types of mobile phones. Customers can record their measurements at home, and see what different models of clothes will look like in their size, before going to one of the retail centres, luxury stores, or ordering the clothes online. SDG does not charge customers to use the App, and does not restrict the downloads of the App, as it is considered to be an important marketing asset for the Group.

SDG are also able to market their custom clothes through targeted online advertising. Customers can buy custom clothing through the App from *Virtually Sophia Kft.* The orders are processed by the Hungarian-based sales team and created at the retail centre closest to the customer. Deliveries are then made through the fleet of *electric (driverless) cars* and *drones* leased by SDG from an unrelated Romanian Company.

Customer deliveries in this manner are expected to be a temporary solution as technological advances promise to bring SDG's 3D printing technology into homes in the very near future. When that technological break-through occurs, SDG are poised to be leaders in fashion retail by selling directly into their customers' homes. Customers will simply download the printing pattern for their chosen clothes, link their measurements from the App and press print!

A functional analysis of Sophia's Dream Group is given as an appendix to this case study (pages 7-13).



DIPCAT Case 2
Sophia's Dream Group Case Study Tasks
ISP – September 2019

1. **Taxing Puzzle:** Taxing nexus is dynamic. Tax advisers must continually review their entities' changes in business activity, physical and economic presence in other taxing jurisdictions.

Your first task is to identify the various taxable entities of Sophia's Dream Group, the countries in which each may be liable to tax, and the persons/entities liable to such taxation.

Learning and Reference Materials:

- Video recording on permanent establishments (BEPS Action 7)
- National legislation on taxation of non-resident persons for relevant countries
- Article 5 of the [2017 OECD Model Tax Convention](#), paragraphs 1, 2, and 4, specifically)
- OECD Commentary (paragraphs 6, 8, 12, 20-26, 28-30. 41, 45, 58-60, and 68 only) to Article 5.

2. **Profit Attribution and Transfer Pricing Exercise:** Profit attribution to permanent establishments must be systematically and fairly determined. Further, transactions between associated entities must be continuously reviewed.

Your second task is to consider the information provided within the functional analysis regarding the vertically-integrated supply chain of Sophia's Dream Group. Identify the various and numerous intra-group transactions that must be considered for potential profit attribution and transfer pricing issues.

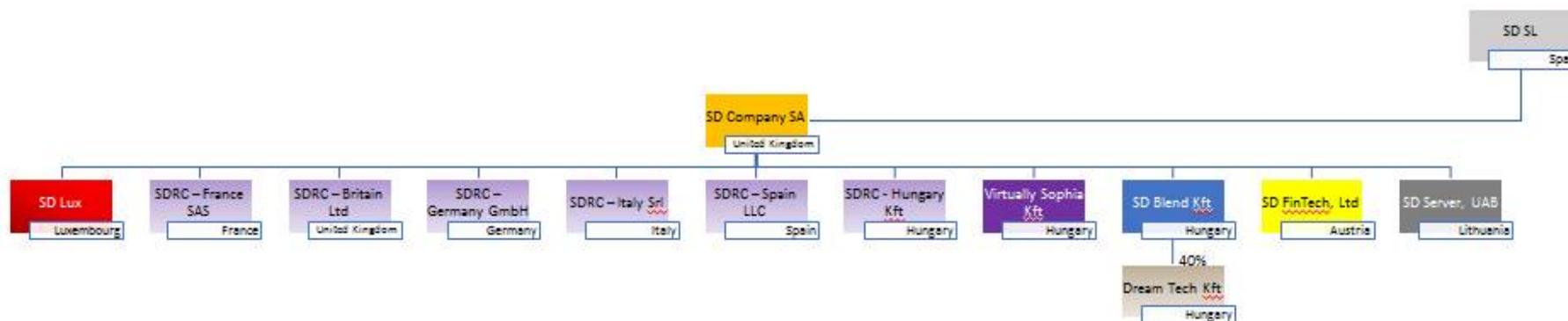
Learning and Reference Materials:

- video recording(s) on transfer pricing (BEPS Actions 8-10; 13);
- Article 9 of the [2017 OECD Model Tax Convention](#)
- OECD Commentary (paragraphs 1-2, 5-6 and 11 only) to Article 9
- [OECD \(2017\) Transfer Pricing Guidelines](#)
 - Chapter 1, Sections A&B (pages 33-38)
 - Chapter 2, Part I, Section A (pages 97-100)
 - Chapter 2, Part II, Sections A-D (pages 101-117)

3. **Court Room Finale** Given further information on SDG's transactions for critical analysis; prepare a case for court from the perspective of an assigned tax adviser or tax authority (to be determined).



Appendix: The Group's Functional Analysis



Company	Functions performed	Assets controlled	Risks borne
Sophia's Dream SL (registered and tax resident in Spain) 	<p>Shareholders: three siblings of the De Sousa Family (Maria (50%), Alberto (25%), and Teresa (25%)).</p> <p>Holds 100% of the shares in <i>Sophia's Dream Company SA</i>.</p> <p>Maintains the shareholder registers for SDC SA and its subsidiaries and determines group dividend policy.</p> <p>Determines the strategic direction and overall trading policies of the whole group.</p> <p>Alberto De Sousa holds 25% of the shares in <i>New Tech SC</i> in Romania (see below).</p>	<p>Shareholding of SDC SA</p> <p>50% key strategic staff</p> <p>Unused group financing amounts</p> <p>premises</p>	<p>Loss of key staff</p> <p>Rises in property taxes and rents</p> <p>Brexit</p>



<p>Sophia's Dream Company SA (incorporated in Spain; physically moved to the UK in 2010; tax residence is to be considered periodically)</p> 	<p>Headquarters (HQ) – holds 100% of the shares in each of the Group's first-tier subsidiaries with the exception of <i>New Tech SC</i> in Romania (see below); significant administrative functions for the Group; receives annual HQ fees and dividends from all subsidiaries.</p> <p>Research and Development Division of the Group which:</p> <ul style="list-style-type: none"> - Develops the core eco-fashion software which drives the 3D printers used to make clothes in retail centres for direct customer sales in various countries; - Develops clothes design pattern software which is then produced using the 3D printers. Prototypes made from the software patterns are displayed at Fashion Shows in London, Paris, Milan, Madrid, Budapest and Berlin (the software is sublicensed to <i>SD retail centres</i> in various countries for production); - Develops the knowhow for 3D Printers that are able to reproduce/manufacture Sophia's Dream clothes (the printers are manufactured in SD FinTech Ltd, Austria); - Develops the software for interactive holograms of fashion models that are displayed in luxury department stores and major city centres' high streets, (the projectors are manufactured in SD FinTech Ltd, Austria); - Develops Sophia's Dream Fit app that takes precise customer measurements to ensure the perfect fit of every article of clothing. <p>There is a <i>branch</i> in Hungary with a small number of autonomous employees who develop customer databases and marketing tools, using sophisticated indexing software which has also been developed over the</p>	<p>50% key strategic staff</p> <p>Eco-fashion development software and knowhow</p> <p>Clothing design software development and knowhow</p> <p>3D Printer development: hardware and knowhow</p> <p>Hologram development: software and knowhow</p> <p>Dream Fit App development; knowhow</p> <p>Database development: software and knowhow</p>	<p>Obsolescence of technical knowhow</p> <p>Emergence of competitors in eco-fashion provision market</p> <p>Defection of skilled staff who might share their knowledge with competitors</p> <p>Interest Rate Risk</p> <p>Brexit</p>
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<p>Sophia's Dream Company SA (continued)</p> 	<p>years by employees. Data and feedback from the use of holograms and information from Sophia's Dream Fit App contribute to these databases. The branch employees are based in the offices of <i>Virtually Sophia Kft</i>.</p> <p>The resulting intellectual property (i.e. patents, copyrights, knowhow brand, trademarks and various marketing databases and tools) are transferred to <i>Sophia's Dream Lux SARL</i> (SD-Lux) as soon as the products are considered to be technologically viable. This is done by granting SD-Lux exclusive, indefinite leases on payment of upfront lump sums that more than cover the direct and indirect costs of the R&D, together an agreement by SD-Lux to pay nominal fixed royalty payments. Although ultimate ownership of SDG's intellectual property is retained by Sophia's Dream Company SA, the practical exploitation of the rights is transferred and managed in Luxembourg.</p>	<p>Client base Skilled workforce Premises</p>	
<p>Sophia's Dream Lux SARL (Luxembourg)</p> 	<p>Company with IP exploitation functions.</p> <p>It holds exclusive licences for SDG's IP and, in turn, grants sub-licences over that IP to SDG's retail centres, luxury stores and marketing teams. The sub-licenses permit the retail centres and luxury stores to make direct sales to customers in return for the payments of royalties to <i>SD-Lux SARL</i>. The value of royalties charged is substantial, which is reflective of the underlying value of the IP once it became viable.</p> <p>The company also sub-licences certain IP on a manufacturing-only basis, being the IP relating to:</p> <ul style="list-style-type: none"> - the blends, which is licensed to SDB Kft - the printer IP and hologram projector IP, which is licensed to SDFinTech <p>A small group of highly experienced lawyers ensure the IP protection as well as oversight of basic registration and administration functions.</p>	<p>Exclusive rights of the intellectual property</p> <p>Staff: a small group of highly skilled lawyers</p>	<p>Unsuccessful defence of copyrights and IP</p> <p>Interest Rate Risk</p> <p>Brexit</p>



<p>Sophia's Dream Retail Centres: SDRC-France SAS SDRC-Germany GmbH SDRC-Spain LLC SDRC-Italy Srl SDRC-Britain Ltd SDRC-Hungary kft</p> 	<p>Retailer Centres of eco-fashion</p> <ul style="list-style-type: none"> - Coordinate the fashion shows within each country and provide after-sales support to customers in those countries; - Spaces are rented; tend to be located in luxury shopping centres; - House 3D printers used to produce clothing for retail (purchased from <i>SD FinTech Ltd</i>); - Purchases the raw printing material for producing clothing from <i>Sophia's Dream Blend, Kft</i>; - Manages the distribution of clothing to online customers of <i>Virtually Sophia Kft</i> for processing and delivery costs and a nominal commission; - Leases electric cars and drone for deliveries, exclusively for Sophia's Dream products. 	<p>Sub-licenses for the technical soft/hardware</p> <p>Basic technical knowhow to operate the printers and hologram projectors</p> <p>A group of skilled staff</p> <p>Electric cars and drones</p>	<p>Rises in property taxes and rents</p> <p>Loss of skilled workforce to competitors</p> <p>Increases in the costs of the blends</p> <p>Liability of operating driverless cars and drones</p> <p>Brexit</p>
<p>New Tech SC (Romania)</p> 	<p>Manufacturing company to which SDG is its largest client, accounting for 80% of their net profits.</p> <p>Alberto De Sousa owns 25% of the shares and the remaining 75% is owned by 1 cousin and 2 close friends from University.</p> <p>The company manufactures and services electric vans, cars and drones for various clients, including SDG, on long-term leases.</p>	<p>Vehicle/drone fleets</p> <p>Insurance and maintenance contracts for vans, cars and drones</p> <p>Skilled staff</p> <p>Premises</p>	<p>Claims of mechanical or operating problems with the vans cars and drones</p> <p>Loss of skilled workforce to competitors</p> <p>Rises in taxes</p>



<p>Dream Tech JV-SC (Hungary)</p> 	<p>New Tech SC has entered into a Joint Venture with Sophia's Dream Blend Kft, forming a separate legal entity: Dream Tech JV SC, registered and effectively managed in Hungary. New Tech SC has a 60% interest in the JV, and SDB Kft has the remaining 40% interest.</p> <p>The JV manufactures and maintains transportable workshops for exclusive use by SDG:</p> <ul style="list-style-type: none"> - Manufactures machines which are housed in trailers which are hitched to New Tech electric vans; - Sells the full transportable workshop (machines, trailers and vans) to Sophia Dream Blend Kft at what is proposed to be the FMV for this innovation. - Provides after-sales maintenance contracts to SDB Kft for a reasonable fee 	<p>Contract with SDG to develop and manufacture transportable workshops</p>	<p>Mechanical problems with the movable workshops</p>
<p>Sophia's Dream Blend Kft (Hungary)</p> 	<p>Manufacturing company which produces the raw printing material, <i>Sophia's Dream Blend</i>, for use in the 3D Printers</p> <p>Purchases transportable workshops from Dream Tech JV SC.</p> <p>Deploys and operates workshops in Greece, Netherlands and Portugal:</p> <ul style="list-style-type: none"> - traveling between farms in the 3 countries; - collecting by-products (tomato vines and tulips) for nominal fees to farmers, - processing by-products into pastes while on site, producing pastes <p>The pastes are then transported to the Hungarian Factory for further processing.</p> <p>Refines and combines pastes with natural fibres from deconstructed (upcycled) clothing to create the raw printing material, <i>Sophia's Dream Blend</i>, for use in the 3D Printers.</p>	<p>Factory and land</p> <p>Mobile processing units (workshops)</p> <p>long term supply contracts with farms for raw materials</p>	<p>Weather and similar risks to crops – lack of availability of raw material</p> <p>Mechanical problems with the movable workshops</p> <p>Increases in the costs of the blends</p> <p>Shortages of blend on demand</p>



<p>Sophia's Dream Blend Kft (Hungary) (continued)</p> 	<p>Purchases the natural fibres used in the raw printing material from third parties (charities and other sources for second hand clothing)</p> <p>Sells the blends to <i>Sophia's Dream Retail Centres</i> on demand.</p>		<p>Loss of skilled workforce to competitors</p> <p>Rises in property and corporate taxes in Hungary</p> <p>Brexit</p>
<p>Virtually Sophia Kft (Hungary)</p> 	<p>Employs 30 sales and marketing experts to:</p> <ul style="list-style-type: none"> - maintain and develop the online presence of SDG; - receive/fill orders through the online site; - Liaise with retail centres that fill online orders by processing and delivering to geo-specific customers. <p>The server used by VS Kft for the SDG online presence is leased from an external provider in Lithuania.</p> <p>Offices provided to SDC SA employees that develop customer data bases and marketing tools.</p>	<p>Highly trained staff, premises</p> <p>Leased server</p>	<p>Staff being poached</p> <p>Destruction or disturbance of the online provision.</p> <p>Brexit</p>
<p>Sophia's Dream FinTech Ltd (Austria)</p> 	<p>Provides centralised finance and technology co-ordination for SDG</p> <p>Financing Division (25 employees):</p> <ul style="list-style-type: none"> - Borrows in bulk from external banks (no other companies within the Group have any external borrowings); - Makes finance available to the operating companies, sometimes in the form of cumulative, redeemable, fixed-rate preference shares; - Deals with SDG's foreign currency requirements. 	<p>Cash balances</p> <p>Loans outstanding and preference shares from other</p>	<p>Interest rate risk,</p> <p>Currency risk (both these are usually hedged)</p>



<p>Sophia's Dream FinTech Ltd (Austria) - <i>continued</i></p> 	<p>The interest rates charged by <i>Sophia's Dream FinTech Ltd</i> to other group companies are at open market rates.</p> <p>Technology Division (25 employees):</p> <ul style="list-style-type: none"> - Provides 24/7 IT support to SDG; - Manufactures hologram projectors to specifications developed by SDC SA - Supplies and maintains hologram projectors in luxury stores and provides after-sales support services to the stores; - Provides support services for hologram projectors in SDG retail centres; - Manufactures 3D printers to specifications developed by SDC SA - Supplies and maintains printers in luxury stores and provides after-sales support services to the stores; - Provides maintenance services for printers in SDG retail centres; - Maintains Sophia's Dream Fit App; - Collects data from interactive holograms and SD Fit App and transfers data to SDC SA branch in Hungary <p>Sells projectors and printers to external stores, but provides these free of charge to SDG's retail centres. Charges technical service fees from luxury stores, retail centres, and SDC SA for the above technical services.</p> <p><i>Sophia's Dream FinTech Ltd</i> was granted a tax ruling by the Austrian Government in 2011 which provides that corporation tax payable by the Company in Austria will be at an effective rate of 1% of profits before taxation each year until 2021.</p>	<p>Subsidiaries in the Group</p> <p>Technical services for maintenance of the printers</p> <p>Technical services for maintenance of the hologram projectors</p> <p>Skilled staff</p> <p>Premises</p>	<p>Liability if printers are not promptly fixed</p> <p>Challenge over the favourable tax arrangement Rises in property and corporate taxes in Austria</p> <p>Loss of skilled workforce to competitors</p> <p>Brexit</p>
<p>Sophia's Server UAB</p> 	<p>Dormant Subsidiary that once owned the SDG server; now a server is leased from an external provider.</p>	<p>none</p>	<p>none</p>