Base Erosion and Profit Shifting (BEPS)

The Organisation for Economic Co-operation and Development (OECD) action plan on addressing BEPS is aimed at government concern about the potential for multinational companies (MNCs) to reduce their tax liabilities through shifting of income to no-tax or low-tax countries. In October 2015, after lengthy negotiations, the OECD and 20 countries published revisions to tax principles, which are based on a 15-point action plan for BEPS. Over the past 12 months, some of these measures have already taken effect.

Driver
Regulatory framework is tightening
- Intercompany transactions under greater scrutiny
- Complexity in global organizational structure and proliferation in legal entities
- Media spotlight on tax structuring arrangements (increased reputational risk)
- Tax authorities becoming more sophisticated
  - Increasingly sophisticated approaches to tax audits
  - Increasing focus on transfer pricing arrangements

Challenges
- Revamped transfer pricing initiatives to reflect actual activities
- Simplification
- Robust documentation

Imperatives
- Aligning functional profile across value chain to mitigate the tax, audit and reputational risk
- Capitalizing on opportunities to manage the group effective tax rate

Examples of operating model implications
- BEPS actions can change the legal and regulatory framework in many countries

BEPS represents one of the most fundamental overhauls of international taxation for a generation.

Impact on your enterprise
BEPS touches every aspect of your organization. You must be prepared to respond effectively across all areas.

Strategy
- Business environment
- Operating models
- Reputation and brand
- Governance and risk
- Expansion vs. contraction

Operations
- Customer and sales
- Procurement and business operating models
- Intragroup transactions
- Global workforce
- Services and intangibles
- Network infrastructure and IT infrastructure

Infrastructure
- Tax compliance and reporting
- Financial statement reporting
- Finance and treasury
- Technology and info/IT
BEPS impact on dealmaking in the telecom sector

A steady flow of cross-sector transactions, comprising 50% of deals in the last three years, reflects operator moves to diversify revenue streams and target emergent digital opportunities. Telcos are building out their service portfolios by acquiring new capabilities in key segments, including over-the-top (OTT) video, IT services, digital advertising and the Internet of Things (IoT). Tapping opportunities in key industry verticals is a focus, with sectors including financial services, transportation and health care driving cross-sector deals.

- 48% of telecommunications executives indicate that they are actively pursuing a merger or acquisition in the next 12 months, up from 43% 6 months ago.
- 37% indicate that they have five or more deals in the pipeline; 49% of these deals are valued at US$250m or less.
- 71% indicate that acquiring talent is the most important or second most important strategic driver for pursuing an acquisition outside their sector.
- 49% cite sector convergence and increases in competition from companies in other sectors as the biggest disrupter to their core business.
- 43% say that the impact of digital technology on their business model is the most prominent issue on the boardroom agenda.
- 67% are shifting skills and talent within the business to gain efficiencies from greater automation.

Sector convergence and advances in technology and digitalization are altering the telecommunications landscape. As companies seek to adapt and excel by reimagining business models and making the most of innovation and automation, talent has become a key priority to drive both the corporate strategy and deal intentions, according to the most recent edition of the Capital Confidence Barometer.

As more telecoms expand operations into multiple countries, considerations of the implications of BEPS legislation will become critical when planning corporate and acquisition strategies.
Typical areas of action in the telecom sector: background

Key themes:
- **Transparency** between taxpayers and government authorities (including automatic exchange of information)
- **Substance**, so that tax follows the source of profits; more attention to matching economic substance to tax
- **Coherence** between individuals countries’ tax systems

1. Address the tax challenges of the digital economy
2. Neutralize the effects of hybrid mismatch arrangements
3. Strengthen controlled foreign corporation rules
4. Limit base erosion via interest deductions and other financial payments
5. Counter harmful tax practices, taking into account transparency and substance
6. Prevent treaty abuse
7. Prevent the artificial avoidance of PE status
8. Consider transfer pricing for intangibles
9. Consider transfer pricing for risks and capital
10. Consider transfer pricing for other high-risk transactions
11. Establish methods to collect and analyze data on BEPS and actions to address it
12. Require taxpayers to disclose aggressive tax planning arrangements
13. Re-examine transfer pricing documentation
14. Make dispute resolution mechanisms more effective
15. Develop a multilateral instrument
Typical areas of action in the telecom sector: background

**Minimum standards:** implementation by participating countries of minimum standards in national laws, tax treaties and other local requirements

**Reinforced standards:** tightening of existing OECD Transfer Pricing Guidelines and the OECD Model Tax Convention

**Common approaches and leading practices:** optional building blocks to help countries implement revisions

- **Immediate impact**
  - Action 8 — Transfer pricing for intangibles
  - Action 9 — Transfer pricing for risks and capital
  - Action 10 — Transfer pricing for other high-risk transactions
  - Action 13 — Transfer pricing documentation and country-by-country (CbC) reporting

- **Treaty-based action**
  - Action 2 — Hybrid mismatch arrangements
  - Action 6 — Treaty abuse
  - Action 7 — Permanent establishment (PE) status
  - Action 14 — Dispute resolution
  - Action 15 — Multilateral instrument

- **Legislative action**
  - Action 2 — Hybrid mismatch arrangements
  - Action 3 — Controlled foreign corporation (CFC) rules
  - Action 4 — Interest deductions and other financial payments
  - Action 5 — Harmful tax practices

- **Analytical reports**
  - Action 1 — Digital economy
  - Action 11 — Economic analysis of BEPS
  - Action 15 — Multilateral instrument

**Operational**

**Tax**

**Reputational**
Typical areas of action in the telecom sector: Action 13

Master file introduction: gives tax authorities information about countries in which the entity is active, where IP is owned, where revenue is reported, where taxes are paid and intercompany transactions.

Country-by-country (CbC) reporting: companies with annual consolidated group revenue of €750 million or more must provide certain financial information from fiscal year 2016 onward; provides information about the jurisdictional allocation of revenue, profits, taxes, assets and employees.
### Action 13: Key reporting definitions

| Group entities by country and business activity codes | • Use of same data source year to year  
• Reconciliation of CbC reporting to consolidated financial statement not required  
• Use of functional currency of the reporting entity  
• Reporting made on a tax jurisdiction by tax jurisdiction basis |
| --- | --- |
| Revenue and pre-tax earnings | • Revenue: includes sales of inventory and properties, services, royalties, interest and premiums, and other amounts derived from transactions with related or unrelated parties  
• Pre-tax earnings: include all extraordinary items |
| Cash tax and current tax | • Cash tax: includes withholding taxes paid by other entities with respect to payments to constituent entity  
• Current year tax (accrual basis): includes only current-year operations and excludes deferred tax or provisions |
| Stated capital and accumulated earnings | • Stated capital and accumulated earnings: include all constituent entities resident for tax purposes in relevant jurisdiction  
• PE: to be reported by the legal entity of which it is a PE  
• Tangible assets: net book value of tangible assets for all constituent entities resident for tax purposes in the relevant jurisdiction |
| Employee headcount and tangible assets | • Employee headcount: full-time equivalent basis, for all constituent entities resident for tax purposes in relevant jurisdiction  
• Independent contractors participating in ordinary operating activities of constituent: can be reported as employees |
**Action 13: CbC readiness – where is your company in this spectrum?**

1. **Getting started**
   - Understand the rules and application to your company
   - Align on policy decisions
   - Identify both financial and nonfinancial information sources
   - Identify stakeholders and operating model
   - Connect to master and local files and determine gaps

2. **Assess risks and opportunities**
   - Perform an initial dry run and assess current state of CbC profile
   - Identify issues that would be raised by tax authorities
   - Analyze master and local file gaps
   - Recommend and plan structural remediation
   - Finalize a plan for first year implementation and how it will impact follow-on year implementations

3. **Prepare for and conduct year one reporting**
   - Incorporate CbC forms into filing calendars
   - Set up data extraction and year one compliance process
   - Configure audit trail functionality
   - Identify solutions to address data and process challenges
   - Design and implement technology tool or utilize a third-party provider

4. **Sustain future compliance**
   - Implement and/or enhance technology tools
   - Establish data governance
   - Automate data extraction and mapping
   - Improve process and tools for data analytics
   - Improve process for report generation and filing

**Key outcomes**
- Create sustainable process and tools
- Automated reporting and analytics

**Key activities**
- Source data and policy decisions
- Create assessment and communication plans
- Create risk assessment and remediation plan
- Develop implementation plan(s)

**Are you ready to meet the CbC requirements?**

How will you collect, analyze and report information?
Have you reviewed and evaluated what the information will show?
Is the information consistent?
Typical areas of action in the telecom sector: Action 7

Change is made to the definition of PE, which is the starting point for the imposition of taxes in a local jurisdiction.
BEPS substantially lowers the threshold under which a host nation can declare a corporate presence as a PE and therefore be subject to income tax.
Telecom companies undertaking common transactions may now be at an increased risk for PE.

Preventing the artificial avoidance of PE status

Proposed changes to the OECD Model Treaty language and commentary regarding the definition of a PE:
- Commissionaire and similar sales and marketing models likely to create a PE
- Closely related parties not considered independent
- Article 5.4 activities restricted to preparatory or auxiliary
- Anti-fragmentation rule
- Splitting up of contracts under general anti-avoidance (referenced in Action 6)

Areas for immediate risk assessment
- Commissionaires/sales agent and similar sales models
- Preparatory and auxiliary nature of activities and fragmentation of activities forming part of a cohesive business operation
- Timing of treaty negotiations in relevant countries
- Question of whether changes will be accelerated through the multilateral instrument (90 participating countries)
- Profits attributable to a PE
Typical areas of action in the telecom sector: Actions 8-10

Aligning transfer pricing outcomes with value creation

Six interlinked sections impact risk management:

- Guidance for applying the arm’s-length principle
- Guidance on commodity transactions
- Guidance on the transactional profit split method
- Guidance on intangibles
- Guidance on low value-adding intra-group services
- Guidance on cost contribution arrangements

Intangibles: new technical guidance and compliance requirements

**Action 8**
Guidance on transfer pricing aspects of intangible assets

**Action 13**
Transfer pricing (TP) documentation and CbC reporting

New technical guidance and compliance requirements for MNEs

- New TP documentation requirements given by OECD BEPS Action 13 report are wide in scope.
- Action 8 and Action 13 are closely interconnected.
  - Tax authorities to examine whether the MNE’s overall strategy, and TP policy and TP practice in relation to intangibles, is in line with Action 8 guidance.
  - It is imperative for MNEs to evaluate and document their overall strategy and TP policy in relation to intangible assets.
  - TP practice should be reviewed for overall consistency and specifically for alignment with Action 8 guidance.

What to know about Action 8: transfer pricing for intangibles

**Key changes**
- Tackle BEPS via the misallocation of profits generated by valuable intangibles
- Recommend actions that aim to evaluate unreasonably high royalties, license fees, etc.

**Who could be affected**
- Businesses considering changes in activities related to intellectual property (IP) and trademarks
- Businesses with activities that are exempt from value-added tax (VAT)

**Potential VAT implications**
- Retrospective transfer pricing adjustments that may require VAT adjustments through credit notes or new invoices and VAT returns
- VAT that should be calculated over increased or decreased customs value (including royalties and license fees) when dutiable goods are imported
Identifying and defining intangibles

“Something which is capable of being owned or controlled for use in commercial activities and whose use or transfer would be compensated ... between independent parties.”

<table>
<thead>
<tr>
<th>Goodwill and going concern</th>
<th>Goodwill and going concern</th>
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<tbody>
<tr>
<td>• Relationship capital (innovation community, ecosystem and supply chain partnerships)</td>
<td>However, OECD Action 8 guidance explicitly excludes:</td>
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<tr>
<td>• Reputational value</td>
<td>• Group synergies</td>
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<tr>
<td>• Key human capital</td>
<td>• Market-specific characteristics</td>
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<thead>
<tr>
<th>Intangible related returns</th>
<th>Intangible related returns</th>
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<tbody>
<tr>
<td>Non-registered IP (illustrative examples)</td>
<td>TP definition of intangibles wider than legal business or accounting definitions. For example: customer lists, supplier lists, contractual rights, proprietary market and customer data, customer relationships, negative know-how, know-who, copyright in software code</td>
</tr>
<tr>
<td>• Know-how and trade secrets</td>
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<tr>
<td>• Marketing intangibles</td>
<td></td>
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<tr>
<td>• Distribution network and customer lists</td>
<td></td>
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<tr>
<td>• Product design and technology</td>
<td></td>
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<tr>
<td>• Process technology provided to buyers</td>
<td></td>
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<tr>
<td>• Supplier lists and procurement processes</td>
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<thead>
<tr>
<th>Separately identifiable intangible assets</th>
<th>Separately identifiable intangible assets</th>
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<tbody>
<tr>
<td>Registered IP (illustrative examples)</td>
<td>Are you in a position to identify all the intangibles and IP owned, controlled or used in your business and to prove an ownership chain?</td>
</tr>
<tr>
<td>• Patents, designs, licenses and rights</td>
<td></td>
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<tr>
<td>• Trademarks, names, domain names and brands</td>
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<tr>
<td>• Other contractual rights</td>
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The Action 8 deliverable report has inserted a new definition for the term “marketing intangibles” in the glossary of the OECD TP Guidelines (2010), thus replacing and widening the original definition for the same term.

New inserted definition

“An intangible that relates to marketing activities, aids in the commercial exploitation of a product or service, and/or has an important promotional value for the product concerned. Depending on the context, marketing intangibles may include, for example, trademarks, trade names, customer lists, customer relationships, and proprietary market and customer data that is used or aids in marketing and selling goods or services to customers.”
Action 8 focuses on DEMPE functions

- Taxpayers are directed to review the allocation of profits for each development, enhancement, maintenance, protection and exploitation (DEMPE) component with respect to the level and nature of activity undertaken.
- There is no automatic return on account of mere legal ownership of the intangible.
- There is a requirement to directly perform or to control the performance of DEMPE functions and related risks.
- The return retained by an entity in a group depends on the contributions it makes through DEMPE functions to the anticipated value of the intangible relative to contributions made by other group members.

- Functions that have special significance for purpose of functional analysis while arriving at arm's-length compensation:
  - Design and control of research and marketing programs
  - Management and control of budgets
  - Control over strategic decisions regarding intangible development programs
  - Important decisions regarding defense and protection of intangibles
  - Ongoing quality control over functions performed by independent or associated enterprises that may have a material effect on the value of the intangible
  - The return to mere funding may be limited to a risk-adjusted, forward-looking return on capital.
  - Any group companies performing DEMPE functions on behalf of the legal owner must be remunerated accordingly.

The new OECD guidance has moved away from the concept of ownership and has adopted a "transactional approach" with a clear focus on "substance" for conducting TP analysis of intangibles.
Actions 8-10: Six-step framework for analyzing risk

1. Identification of economically significant risks with specificity

2. Determination of contractual assumption of the specific risk

3. Functional analysis in relation to risk

4. Interpretation of steps 1-3

5. Allocation of risk

6. Pricing of transaction, taking into account the consequences of risk allocation

<table>
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<tr>
<th>Area of focus</th>
<th>Key considerations</th>
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<tr>
<td>Risk ownership and related returns</td>
<td>▪ Having the capability to make decisions to take on, lay off or decline a risk-bearing opportunity, together with the actual performance of that decision-making function</td>
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<td></td>
<td>▪ Having the capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision-making function</td>
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<td></td>
<td>▪ Having access to funding to take on the risk or to lay off the risk to pay for the risk mitigation functions and to bear the consequences of risk materialization</td>
</tr>
<tr>
<td>IP ownership and related returns</td>
<td>▪ Controlling the performance of key IP functions and being the DEMPE of the IP, including related assets and risks</td>
</tr>
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Operational transformation: BEPS and the value chain

BEPS is bringing more scrutiny around operational substance, which presents a once-in-a-generation opportunity to align operational and tax business models.

Many of the BEPS action items and countries’ tax legislative developments may impact operating models and planning related to value chains and the development and deployment of IP and the inherent risk management related to the development and deployment of IP.

- Telcos need to solidify the commercial substance underpinning their TP models; have defensible transfer pricing policies in place and strong transfer price setting, monitoring as well as adjustment procedures.

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Management and operation of international networks and centralized value chains

- Development of areas of value creation arising from digital and similar opportunities
- Evolution of transfer pricing models in response to commercial pricing pressures
- Increased scrutiny on operational transfer pricing processes, systems and outputs
- Enhanced integration among tax and operations teams
- New business models for digital requiring TP models to factor in more dispersed value creation around creation and ownership of IP
Typical areas of action in the telecom sector: other relevant actions

In addition to the follow-up technical work, the OECD continues work on the following areas of relevance to telecom companies:

**Countering harmful tax practices (Action 5)**

**Part 1: Substantial activity requirement**
- Nexus approach as the agreed approach
- IP regimes for patents (under a broad definition) and copyrights
- Application of nexus approach to activities other than IP, requiring a link between income qualifying for benefits and the core activities necessary to earn the income
- Grandfathering rules (maximum five years) – no new entrants to existing regimes after June 2016

**Part 2: Improving transparency**
- Framework for the compulsory spontaneous exchange of information on rulings
- Preferential regimes

**Implications:**
- Outsourcing R&D to related parties may result in reduced benefits.
- Outsourcing R&D to third-party contract research organizations (CROs) not expected to result in reduced benefits, but may be capped or subject to a minimum level of “in-house” R&D.
- Acquisition of IP from related or third parties, including licensing, may result in reduced benefits, but fairness of this has been raised to OECD and will be a focus of domestic law implementation.

**Digital economy (Action 1)**

Fundamental conclusion is that the digital economy “cannot be ring-fenced as it is increasingly the economy itself,” and that direct tax challenges will be effectively addressed by other BEPS actions (e.g., Action 3 on CFC, Action 7 on PE and Actions 8-10 on IP and transfer pricing).

**Recommendation**
- Modification to list of PE exceptions to ensure that core activities involving preparatory and auxiliary functions cannot inappropriately benefit from the exception. This includes introduction of new anti-fragmentation rules to deny benefits from fragmentation of certain business activities.
- Modification to definition of PE to address artificial arrangements through “conclusion of contracts” arrangements to avoid PE status
- Updates to the OECD Transfer Pricing Guidelines
- Updates to controlled foreign company rules to address challenges identified in the digital economy
- Application of principles of OECD’s International Value Added Tax/Goods and Services Tax (VAT/GST) Guideline to indirect tax treatment of digital transactions
Development of a multilateral instrument (MLI): mechanism to amend bilateral tax treaties to incorporate the treaty-based BEPS (Action 15)

**BEPS Multilateral Instrument adopted on November 24, 2016**
- Revision of Art. 1 to address fiscally transparent entities
- Measures to address issues with the application of the exemption method
- Minimum standard on treaty abuse: PPT, PPT + simplified LOB or detailed LOB + supplemented conduit rules
- A “saving clause”
- Specific anti-abuse rules
- Certain dividend transfer transactions
- Transactions involving immovable property holding companies
- Situations of dual-resident entities
- Treaty shopping using third-country PEs

**Areas for immediate risk assessment**
The intention of the MLI is to enable jurisdictions to implement treaty-related measures developed in the course of the work on BEPS, including the BEPS minimum standard.

The signature of the MLI will expedite the renegotiation of more than 3,000 tax treaties.

Signature countries will provide a list of the tax treaties they have in force that they would like to be covered by the MLI (i.e., the Covered Tax Agreements).

The MLI will not amend tax treaties but instead will be applied alongside existing tax treaties, modifying their application in order to implement the BEPS measures.

**EU anti-tax avoidance package: BEPS implications**

The EU anti-tax avoidance directive (ATAD) contains five anti-avoidance measures:
- The ATAD provides a minimum level of protection so Member States could implement ATAD more strictly, as well as additional anti-avoidance rules.
- Former drafts contained a switch-over clause, but this clause has been removed in the final version.
- There are several exceptions for financial undertakings given their specific characteristics.

**Potential consequences for US multinationals with operations in Europe could include the following:**
- Higher effective tax rate (ETR), e.g., due to a cap on interest deductions and direct taxation of profits realized by foreign subsidiaries and branches
- Challenge of more structures as a result of the introduction of anti-hybrid rules and GAAR

**General anti-abuse rule**
- Interest deduction limitation rules
- Anti-hybrid rules
- Controlled foreign company rules
- Rules on cross-border transfers of assets, businesses and tax residence
- Anti-hybrid rules
Questions to ask and steps to take for telcos to assess and mitigate risk

**BEPS initiative momentum**

- **Substantial progress in OECD BEPS initiative:**
  - All work streams have now reported back.
  - Country-by-country reporting (CbC) is expected to be introduced in relation to 2016 data.
  - There has been a proliferation of domestic law changes.
  - Progress fuels and informs continued press and NGO interest in tax planning.

- **What is the impact?**
  - Transparency work streams (especially CbC) change the risk and controversy environment.
  - Substance work streams may require a refresh of transfer pricing policies and documentation.
  - Coherence work streams change the overall approach to tax planning and tax risk management.

- **Trends and themes**
  - Increased focus on tax planning and risk management being:
    - Aligned to tax policy
    - Transparent
    - Aligned to business and commercial substance
    - There is a generalized increase in source taxation.

**What are companies doing?**

- **Understanding the risk:**
  - Overall BEPS risk assessment
  - CbC template evaluation
  - Peer benchmarking

- **Addressing substance work streams**
  - Transfer pricing and PE training
  - Transfer pricing policy and documentation review and refresh
  - Permanent establishment risk management policy review and refresh
  - Greater use of unilateral and bilateral advance pricing agreements (APAs)

- **Addressing coherence work streams:**
  - Rebalance capital structure vs. supply chain
  - Restructure finance structures impacted by BEPS measures
  - Revisit hub companies
  - Business alignment
  - Substance
  - Transparency
  - Sustainability
  - Rulings renewal

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**More risk**

1. **Assess**
   - Do a sustainability check of existing operating model/IP strategy/risk management, including direct tax, indirect tax, transfer pricing, IT, operations and human capital implications

2. **Quantify**
   - Evaluate the material impact by quantifying costs of the direct tax, indirect tax, operational, compliance and regulatory risk, and consider the reputational risk

3. **Weigh**
   - Consider available options to mitigate risks – feasibility analysis of the holistic business case underpinning options identified

4. **Decide**
   - Decide, depending on the outcome of the feasibility analysis, whether to maintain, reinforce or redesign the existing structure and review the tax reserves accordingly

5. **Execute and monitor**
   - Design, implement, document and monitor changes – “live the structure”

**Less risk**

- Telecommunications companies in the new environment need to engage extra resources to tackle the increase and quality of scrutiny.
Why EY?

EY’s Telecommunications Tax services
EY Telecommunications Tax service line covers the breadth of advisory and compliance services for both corporate and personal tax

- **Business tax:** provides corporate tax advice throughout every stage of the tax life cycle: planning, provision, compliance and controversy. Also provides personal tax compliance and advisory services for senior executives.
- **Human capital:** offers tax compliance and advisory services to companies and their international or domestic assignees. The services include global mobility advisory, assignment administration, process risk assessments, business immigration and expatriate tax return processing. We also advise clients on performance and reward programs.
- **Indirect tax:** focuses on advisory and compliance services for all aspects and types of indirect tax, including VAT, goods and services tax, and customs duties.
- **International tax:** provides cross-border corporate income tax advice on cross-border financing and structuring, transfer pricing and tax-efficient supply chain management.
- **Transaction tax:** focuses on tax due diligence and transaction support services, including tax-structuring advice.

Tools

- DEMPE tool to quantify the allocation of profit based on DEMPE functions and their respective weight in value creation
- CbC reporting tool
- Presentations for operations, tax and C-suite discussions
- Seminar materials
- Speaker notes
- Support with tailoring and prep88ing for conversations
- Work plans
- Risk assessment and options review
- Conversions (e.g., commissionaire to limited risk distributor (LRD))

Methodology

- Dedicated global, national and regional ITS/TP Operating Model Effectiveness (OME) resources, integrated with OME supply chain, IT, Finance and other Advisory professionals with deep technical and practical experience across all impacted areas
- Global TP/OME working group driving thought leadership on the impact of BEPS
- Foreign desks for local country impacts including ruling reviews

- Outcome-driven, integrated, phased approach to assess, design and implement a tailored risk mitigation strategy
- Six-step approach to assess risk under Actions 8-10
- Six-step process for analyzing the ownership and allocation of returns derived from intangibles

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