

Answer-to-Question- \_1\_

Part A

1) Identify the cross border transactions between associated groups:

Managerial and technical services are provided to associated enterprises

Contract R and D is undertaken in Colobus for other associated enterprises

Sales are made from Dharma to other group entities

Procurement is made in Dharma. Not clear if this is cross border or not.

Goods are transported from Dharma, so likely to involve cross border transaction for transport costs, insurance, customs.

2)

Managerial and technical services to associated enterprises

For services it is important to establish whether a service has actually been provided. Further, if that such service has been provided, the charge should be in accordance with the arms length principal.

A service has been provided if it provides the group member with an economic benefit. Further consideration should be whether that group member would be willing to pay for such service to an independent party.

Charges for such services can be direct. That is, a specific service is provided to group member and that service is identified in the documents between the parties involved

Indirect charging method arise where it is not easy to identify and allocate a cost to a particular group member. As such, the charge may then split across group members using an appropriate allocation key.

It is not clear here whether a direct or indirect charging method issued.

In accordance with the OECD TPG, any related part transaction should be compared to the arms length price by using guidelines by the OECD. As such, full comparability analysis should be undertaken and the assets, functions and risks established. The service provided would need to be delineated so that comparisons can be made.

For services, the OECD would recommend using CUP. If the Cradle group has a comparable internal CUP then this should be used. Alternatively, external CUPS can be used. Alternatively, cost plus or TNMM could be appropriate, as services are usually cost driven.

Cradle could consider whether any of the services would be considered low value. They may then be able to use a cost plus 5% mark in accordance with the OECD.

#### Contract R and D

The OECD would always prefer to use CUP where available. Alternatively external CUPS could be used. Although in the practice they may be difficult to establish.

Sales are made from Dharma to other group entities

Again, CUP would be the required transfer pricing method. Here, there may be internal CUPs within the. Alexis does sell to wholesalers, although this is in a different jurisdictions. Comparability analysis would need to be undertaken to see if this was a comparable CUP as the economic market may be different.

Alternatively, cost plus could be used. This would look at the costs incurred in Dharma and the expected margin expected based on the market, functions performed and risks taken.

Goods are transported from Dharma, so likely to involve cross border transaction for transport costs, insurance, customs.

Again, CUP is the preferred choice. We would need to look to see if there is an internal CUP in the group. Alternatively, Cost plus could be used.

Would also need to consider whether the transport costs are embedded within the sales to associated groups. In order to avoid duplication or double charging these costs.

3)

The price charged for contract R and D undertaken in Colobus is likely to be a significant risk. It doesn't appear to have any particular assets and makes no sales to third parties. It is in a low tax rate country.

Tax authorities may review whether the amount paid for R and D is in accordance with the arms principal. Consideration would need to be made to the steps at 6.34 of the OECD TPG. In particular whether the sub in Colobus has the ability to develop, exploit, protect the intangible (DEMPE). In addition, does the sub have the ability to take on or manage the risk of undertaking the R and D work. If it does, then the charge may be

justified.

A full comparability analysis will need to be undertaken to delineate the transaction with specific review of risk.

## 2) The Spark Group

### 1) Functional Analysis of Spark Group, what steps in practice

Functions, assets, risks

The first step of any functional analysis is to ensure that you understand the business of the MNE. The business that Spark Group operates in does appear to be quite specialist. As such, you would need to ensure that you had members in your team that understood the business and the market it operates in.

The next step is to identify the economic significant activities, assets used and risk that involved between the related parted parties.

In practical terms, functional analysis may be undertaken through letters, questionnaires. Alternatively, face to face interviews or phone interviews could be performed. A note taker should be present during interviews to ensure that accurate information is recorded for future reference.

It may be possible to obtain the information from group level. Alternatively, interviews may need to be had with individual subs to establish how they see their role with regard to value creation based on the assets and risks they take.

It would be sensible to have a good connection with a senior staff member, CEO or similar. They would then be able to facilitate with arranging interviews with subsidiaries.

Given the technical nature of the business, it would be important to have a sponsor.

This is likely to be someone with the group that has a good grasp of the business, the economic environment it works in and the risk involved. The sponsor should have a good relationship with associate members of the group so that relevant information can be obtained.

The functional analysis will need to show what contribution each party brings and how it creates value. It may also be important to visit the sites of the business to help fully understand the assets it has and the functions it performs.

2)

It is suggested that Spark corporation derives at least 50% of its income via R and D for conveyor belts. Intangibles can create significant value and so the tax authorities will be keen to ensure that the correct arms length price is charged for this.

It is important to understand whether Spark Corp is the correct entity within the group to share in the income from exploiting the R and D intangible. It is important to consider the development, enhancement, maintenance, and exploitation of intangibles (DEMPE) in accordance with the OECD guidelines.

3)

The arms length principal is set out in Article 9 of the OECD DTA. This article provides the basis under which related party transactions should be measured. The OECDs approach is that controlled transactions will need to follow the arms length principal, or be adjusted to follow this accordingly.

It is important to complete an appropriate comparability analysis so that the controlled transaction can be accurately compared to uncontrolled transaction between unconnected parties. The controlled transaction will need to be accurately delineated. This will allow for a direct comparison to be made to an uncontrolled transaction taking

into account assets, functions, risks. As well economic circumstances and contractual terms.

If comparability analysis of the controlled transactions in Spark is not undertaken, then a correct transfer pricing method cannot be chosen. The price charged may then as a result not be at arms length.

The OECD set out five relevant comparability factors which should be consider when performing a comparability analysis.

Firstly, it is important to understand the contractual terms (if any) between fastlight and spark corp and between Spark group and other associated members. If contracts are in place, do they reflect what is happening or other functions being performed.

A full functional analysis would need to be undertaken to consider what functions are actually performed, what assets are used and who takes significant risks.

Consideration would also need to be made to characteristics of the property fastlight provides. Finally, any relevant economic circumstances or business strategies should be reviewed.

Once the transaction has been accurately delineated, the arms length principal can be applied using the most appropriate method.

It is very important to perform the comparability analysis correctly. If this performed incorrectly, tax authorities may not recognise the transaction (non recognition). Significantly, this can result in double taxation for the taxpayer.

Part B

3)

## Business restructure

Consider changes in functions, assets, risks

In accordance with the OECD, there is no legal definition of business restructuring. The OECD refer to restructuring as cross border reorganisations of the commercial or financial relations between associated enterprises. Clearly, associated enterprises and multinational groups have the opportunity shift profits or make tax savings by reorganising their affairs. This may create problems for tax authorities from a transfer pricing point of view.

ST Corp HQ in country C

CT rate of 30%

Manufactures and dist confectionery products

Large global brand

R and D

Owns IP

Owns large manuf plant

Prior to the restructuring, Sweet Tooth Group undertakes functions of manufacturing and distribution of confectionary and it also undertakes significant research and development for variations of its products.

We are told that Sweet Tooth Group has assets of a large manufacturing plant. It also owns intangibles such IP, know how and branding. Further, it perhaps creates new intangibles through its R and D work.

We can assume that prior to restructuring it would also have assets of a work force,

customer lists, plant and machinery, stock and inventory.

Sweet Tooth Group was functioning as a fully fledged manufacture and distribution company. It would have risks such as stock obsolescence, foreign exchange, warranty, market changes, R and D risk, IP protection.

Post restructure, ST Corp will no longer undertake an R and D function. Further, it no longer holds any IP which has been transferred to Sub Y.

The risk profile of Sweet Tooth has changed. It continues to undertake manufacturing and distribution, but no longer conducts R and D or holds IP. It appears to be functioning as a contract manufacture and distributor. It pays a royalty of 8% of sales for the use of the IP.

In accordance with OECD, a restructuring should not be treated any differently with respect to the arms length principal compared to any other transaction.

It is important to delineate any transactions appropriately and compare the transactions to that of independent third parties.

Here we must consider whether the principal paid for the IP was on par with the arms length principal. Further, would an independent entity be willing to enter into than contract manufacture arrangement.

It will be important to examine the risk of the parties involved post restructure. Risk assumed is associated with profit potential. ST Corp still manufactures and distributes products. It therefore assumes risk of stock, quality control, distribution. It would need to be considered whether the royalty of 8% paid for use of the IP is considered to be at arms length given the risk assumed by ST Corp.

Transfer if intangible may be difficult to value. The OECD provide guidance on this. ST group would need to consider whether the value they have used is in accordance

with the OECD guidance. Particular regard to risk, ability to assume risk and contractual terms should be looked at. In some circumstances it may be appropriate to look at future value potential of the IP. Tax authorities may be able to look back at the price paid.

ST Corp is providing sub x with an interest free loan. This doesn't appear to be in line with the arms length principal. It would need to be considered whether an adjustment should be made.

A restructuring may bring about cost savings and synergies. Where such synergies are the basis for the restructuring, such synergies should be recorded pre and post restructure. Should there be any changes from the expected synergies, the reasons for this change should be noted. Here, a significant cost saving would be expected given the reduced tax rates in Country D and E compared to the 30% rate in country C.

Further consideration should be made to legislation surrounding controlled foreign companies (CFC rules). ST Group should also consider whether any exit charges may be levied.

It is important that the transactions are delineated and compared to independent uncontrolled transactions otherwise tax authorities could not regain the transaction for tax.

## Part C

8.

1) APAs can either be unilateral, bilateral or multilateral. Most tax jurisdictions will not permit unilateral agreements. This is because it can create problems with regard to double taxation. This can occur when one country's domestic legislation does not allow for a binding agreement with tax payers. This can result in economic double taxation.

Given that the multinational group here operates in jurisdictions which share double tax agreements, it would seem appropriate to apply for a multilateral APA or at least bilateral APAs. A multilateral agreement would provide certainty across all jurisdictions the MNE operates and would help avoid double taxation. It should also help reduce administration costs and risk of audits.

2) Article 25 of the OECD DTA is the mutual agreement procedure (MAP). This article allows for the tax payer to take a case to the tax authorities where they consider that they have not been taxed in accordance with the DTA. APAs are usually considered within the scope of Article 25.

An APA only sets down the transfer pricing methodology for a proposed transaction over a period of time. As such, should things change or the APA not adhered too, disputes could occur, For that reason, Article 25 could be used by competent authorities to resolve disputes.

3) Early reports by the OECD suggested that they did not like safe harbours. It was considered that they could have an adverse affect on pricing which would move away from the arms length principal. This could arise because MNEs could set their prices to be within safe harbour limits, such prices not necessarily in line with the arms length principal. Income may also be overstated in some countries in order to bring prices within safe harbour limits.

There has been change in view recently and the consensus is that safe harbours should be developed for low transfer pricing risk. This would seem justifiable as safe harbours provide simplification for compliance issues, provide certainty for taxpayers.

The benefit to the tax authority would be that they could concentrate their resources on more serious high risk transactions.

Countries should carefully weigh up the benefits of safe harbours. Bilateral or multilateral safe harbours may provide a significant benefit.

7)

1. Transfer pricing began as a management tool and forms the basis for examining how parts of a multinational group perform. Management would want to see prices charged on arms length basis so that they could accurately compare the business internally and against competitors internally.

An entity within a group may be performing many functions independently of the group. It could be trading with third parties at arms length basis. Further, any inter group transactions may have been adjusted so that they are at an arms length basis.

It is therefore clear that an entity of a larger group could be making losses even though the group is profitable, Further those losses do not need to be in respect of transfer pricing issues. They may be as a result of a difficult economic climate, regional competition, bad management decisions, lack of control on costs.

If losses are arising on one entity, it is even more important to have a robust transfer pricing policy in place, Any controlled transactions should be accurately delineated. The functions, assets and risks involved in creating value should reviewed and the appropriate transfer pricing method applied. If the controlled transactions are at arms length, then there should not be a particular issue with loss making part within the overall group.

2) Customs valuations can be can be a good indicator of the arms length principal. However, customs may not apply the OECD guidelines in the same way. This can create differences.

Customs valuations may however be useful for comparison because customs may have additional information which can be used for transfer pricing purposes.

However, taxpayers may have competing reasons for the prices used. For customs,

they may want the price to be low so that they pay less duty but for tax purposes they would want to achieve a higher price to pay less tax.