THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

June 2019

MODULE 3.03 – TRANSFER PRICING OPTION

SUGGESTED SOLUTIONS

PART A

Question 1

Part 1

The key transactions between associated enterprises in the Cradle group are:

Alexus

- Purchase of finished goods from Dharma (or possibly not a purchase transaction depending on clarification of facts regarding contract manufacturing arrangement with Dharma).
- Provides intellectual property to Dharma.
- Provides technical and managerial services to Bablas.
- Provides technical and managerial services to Colobus.
- Provides technical and managerial services to Dharma.
- Receipt of research and development services from Colobus.
- Grants Dharma the right to contract manufacture for group.

Bablas

- Purchase of finished goods from Dharma or possibly Alexus or possibly not a purchase transaction depending on clarification of facts regarding contract manufacturing arrangement with Dharma).
- Receipt of technical and managerial services from Alexus.

Colobus

- Performs Research and Development for Alexus.
- Receipt of technical and managerial services from Alexus.

Dharma

- Sale of finished goods to Alexus and Bablas (or possibly not sales transaction depending on clarification of facts regarding contract manufacturing arrangement with Alexus).
- Use of intellectual property from Alexus.
- Receipt of technical and managerial services from Alexus.
- Performs contract manufacturing for Alexus.

Part 2

Consistent with chapter 2 of the 2017 OECD Transfer Pricing Guidelines (OECD Guidelines), the most suitable transfer pricing methodology should be chosen based on the specific facts and circumstances. It is acknowledged that limited factual information is provided and some assumptions may be required to be made.

It is expected that students consider application of the basic traditional transfer pricing methods (Comparable Uncontrolled Price, Cost Plus and Resale Price Methods) and transactional methods (Transactional Net Margin Method and the Profit Split Method). Further, they should briefly justify which method is the most appropriate to the transactions based on the facts provided.

Based on 2.2 of the OECD Guidelines 'the selection of a transfer pricing method always aims at finding the most appropriate method for a particular case'.

Comparable Uncontrolled Price (CUP) method is typically used as the most direct and reliable method with less complex transactions, where sufficiently reliable external or internal comparable data may be found in respect of services performed or products offered in comparable circumstances. Where there are differences in the nature of services or products offered in the uncontrolled transactions, from the subject (controlled) transaction that have a material effect on price - then the CUP method cannot be reliably applied. For example, the intellectual property of Cradle may not be something the parent entity would willingly supply to any third party, not under its direct control.

The OECD Guidelines at 6.205 indicated that..''Where the tested party does not use unique and valuable intangibles, and where reliable comparables can be identified, it will often be possible to determine arm's length prices on the basis of one-sided methods including the CUP, resale price, cost plus and TNMM."

Alexus owns intellectual property for the group. Trade or brand names are considered intangibles for transfer pricing purposes and the OECD Guidelines at 6.82 set out the rationale: ..." where use of the name provides a financial benefit to members of the group other than the member legally owning such intangible, it is reasonable to conclude that a payment for use would have been made in arm's length transactions."

The party that controls this economically significant risk can charge a licence fee to associated entities for the use of the brand name and pricing would usually be based on CUP data analysis, and may include making reasonable adjustments to the benchmarked data set to improve reliability of the comparable.

Based on the facts, consideration needs to be given to the functions performed, assets used, and risks assumed by the users of the intellectual property in creating or enhancing the value of the name in its jurisdiction. However, a separate licence fee may not be appropriate in circumstances where the intellectual property owner is selling finished goods to associates at an arm's length price (otherwise there would be double counting).

As Dharma carries out routine services for the other group entities (contract manufacturing, logistics, procurement etc), a CUP is likely to be considered to price the controlled transactions. This is also likely to be the case for the service transactions (managerial and technical services) provided by Alexus to associates. Alternatively Cost Plus method is also acceptable. As these services are supportive in nature and not part of the core profit making activities of the group, they are likely to be classified as 'low value-adding intra-group services' for the purposes of the simplified approach.

The OECD Guidelines recommend that no benchmarking study needs be completed for low value-adding services, and instead a simplified approach can be used where the provider of such services "...shall apply a profit mark-up to all costs in the pool with the exception of any pass-through costs as determined under paragraphs 2.99 and 7.34. The same mark-up shall be utilised for all low value-adding services irrespective of the categories of services. The mark-up shall be equal to 5% of the relevant cost as determined in Section D.2.2."

Under the arm's length principle, services that provide an economic or commercial value to enhance or maintain the business position of group entities are recognised for transfer pricing purposes. However, the important aspect is that the party that is remunerated for research and development activities must have the capability to perform and control functions of the intangible. The party must also be able to assume the related risks.

Based on the facts provided, Colobus is domiciled in a low tax jurisdiction with minimal staff (2). Based on this information, the entity may not have the capacity to undertake these functions and control the operations. A functional analysis is required to be undertaken to ascertain who is supplying such expertise. A cost plus may be considered the appropriate method. The OECD Guidelines (6.79) further support that compensation based on a reimbursement of cost plus a modest mark-up is appropriate for R&D arrangements.

The Transaction Net Margin Method (TNMM) examines the net profit relative to an appropriate base (e.g. costs, sales, assets) that a taxpayer realises from a controlled transaction. The TNMM operates in a similar manner to the cost plus and resale price methods. A functional analysis of the controlled and uncontrolled transactions is required to determine whether the transactions are comparable and what adjustments may be necessary to obtain reliable results. A strength in this includes that the net profit indicators are less affected by transactional differences than is the case with price, as used by the CUP method. Also, net profit indicators may be more tolerant to some functional differences between the controlled and uncontrolled transactions than gross profit margins.

As with any one-sided method, it is necessary to examine a financial indicator for only one of the associated enterprises (the tested party) which is a benefit when one of the entities party to the transaction are complex and has many interrelated activities or lack of information. Weaknesses include being influenced by some factors that would either not have an effect, or have a less substantial or direct effect, on price or gross margins between independent parties. Also requires information on uncontrolled transactions that may not be available at the time of the controlled transactions as well as may not having enough specific information on profits attributable to controlled transactions including operating expenses. Net profit indicators may also be affected by forces operating in the industry.

Based on the information provided, the TNMM could be applied to Bablas's distribution activities. A profit level indicator of Earnings Before Interest and Tax (EBIT)/Sales may be appropriate in benchmarking the distribution activities.

Transactional profit split method

The profit split method seeks to eliminate the effect on profits of special conditions made or imposed in a controlled transaction by determining the division of profits that independent enterprises would have expected to realise from engaging in the transaction. Can also be losses split. Splits those combined profits or losses between the associated enterprises on an economically valid basis per an arm's length agreement. A main strength is that it can offer a solution for highly integrated operations for which a one-sided method would not be appropriate. Also, when both parties may be found to make valuable contributions to the transaction and therefore a two-sided method is more appropriate. If this is not the case, then it would not be appropriate. Less likely that either party to the controlled transaction will be left with an extreme or improbable profit result. A weakness is in the application in terms of accessing information for offshore affiliates and to identify the operating expenses to allocate.

Based on the facts, it is unlikely that the profit split method would have application.

Part 3

The major risks from a transfer pricing perspective based on the facts are as follows:

Based on the financial information, Alexus has made consistent losses and has not earned an arm's length return based on the returns made particularly by Colobus and Dharma.

The OECD Guidelines (6.32) states "the determination of the entity or entities within an MNE group which are ultimately entitled to share in the returns derived by the group from exploiting intangibles is critical."

It appears that Colobus and Dharma are earning a significant share of the group's profit, despite not legally owning IP. Further, based on the functions undertaken by Colobus and Dharma, they should not be earning the margins indicated by the 2018 financial table. Colobus only has two employees, yet is earning a net profit margin of 88%. A functional analysis should be undertaken, but this entity may not have the capacity to undertake research and development in relation to the maintenance of the intellectual property (refer to B.4.2 of OECD Guidelines). The OECD guidelines indicate compensation based on a reimbursement of cost plus a modest mark-up is appropriate.

Reference is made to Chapter VI of the OECD guidelines (Special considerations for intangibles). Paragraph 6.32 addresses the importance of the entities within an MNE group which are ultimately entitled to a share in the returns derived by the group from exploiting intangibles. Consideration should be given to which entity or entities within the group should bear the costs, investments and other burdens associated with the development, enhancement, maintenance, protection and exploitation of intangibles. Members of the MNE group should be compensated for their contribution under the arm's length principle.

An additional risk is that Alexus may not have been compensated for providing technical and managerial services to associated enterprises.

Refer to Question 1 (1) for the transfer pricing methods that should have application to the transactions. One might expect a return cost plus 5% on routine type functions (although this is not true in all cases, and the particular facts are always determinative).

Alexus has consistently returned losses. D.3. Of Chapter 1 of the OECD Guidelines cover instances where an associated enterprise consistently realises losses whilst the overall MNE group is profitable. Whilst there are reasons why losses may be incurred, an independent enterprise would not tolerate losses indefinitely. Based on the facts, consideration should be given as to why Alexus is doing so.

In summary, the risk appears to be that Alexus is not being compensated for associates within the group using its Intellectual Property based on the fact that Colobus and Dharma are earning profits which do not appear consistent with the arm's length principle (based on their functions, assets and risks).

Question 2

Part 1

The OECD Guidelines define a functional analysis as "The analysis aimed at identifying the economically significant activities and responsibilities undertaken, assets used or contributed, and risks assumed by the parties to the transactions.

In order to undertake a functional analysis of Cradle group, reference is made to the 2017 OECD Transfer Pricing Guidelines, Chapter 1, D1.2.

Consistent with the OECD Guidelines, the steps to be undertaken are:

D.1.2.1 - Analysis of risks in commercial or financial relations

- Identify the material risks assumed by each party in order to accurately delineate the actual transaction in respect of that risk (the level and assumption of risk are economically relevant characteristics that can be significant in determining the outcome of a transfer pricing analysis).

- D.1.2.1.1 - Identify economically significant risks with specificity.

- D.1.2.1.2.- Determine how specific, economically significant risks are contractually assumed by the associated enterprises under the terms of the transaction.

- D.1.2.1.3 – Determine through a functional analysis how the associated enterprises that are parties to the transaction operate in relation to assumption and management of the specific, economically significantly risks, and in particular which enterprise/s control functions and risk mitigation functions, which enterprise/s encounter upside or downside consequences of risk outcomes, and which enterprise/s have the financial capacity to assume the risk.

- D.1.2.1.4 – Steps 2-3 will have identified information relating to the assumption and management of risks in controlled transaction. The next step is to interpret the information and determine whether the contraction assumption of risk is consistent with the conduct of the associated enterprises and other facts of the case by undertaking analysis.

- D.1.2.1.5 – Where the party assuming the risk under steps 1-4 (i) does not control the risk or does not have the financial capacity to assume the risk, apply the guidance on allocating risk.

- D.1.2.1.6 - The actual transaction as accurately delineated by considering the evidence of all the economically relevant characteristics of the transaction as set out in the guidance in Section D.1, should then be priced taking into account the financial and other consequences of risk assumption, as appropriate allocated, and appropriately compensating risk management functions.

- D.1.3 – Characteristics of property or services.

- D.1.4 – Economic circumstances.

- D.1.5 – Business strategies.

From a practical perspective, a functional analysis would be undertaken by reviewing the publicly available documentation regarding the functions of the MNE (websites etc.) for background information. Certain information may be obtained such as the corporate organisational chart, a staff organisational chart of potential staff identified from the key functional operational areas. Duty or job descriptions should be obtained and interviews/discussions with staff in order to gain a better understanding of the business, including interactions between foreign associates. This will include the decision making, communication, business strategies and risks borne.

The global value chain should be understood with the value adding performed by the various parties. The legal rights and obligations of each of the parties in performing the functions should be considered.

The functional analysis focuses on what each of the parties do in practice and what capability they provide. The economic significance of the economic value of the functions of the parties is important. The process of identifying the economically relevant characteristics of the commercial or financial relations should include consideration of the capabilities of the parties, and whether similar capabilities are reflected in potentially comparable arm's length arrangements (para 1.53 of Guidelines).

Part 2

The likely characterisation (additional research and discussions with the key staff of Spark group would need to be undertaken) of each enterprise is as follows:

Enterprise	Summary of Key functions	Likely characterisation
Spark Corporation	Legal ownership of conveyor belt manufacturing IP and other know how.	Entrepreneur as manufacturer and owner of groups intellectual property.
	High value consulting services. Technical services to associated enterprises.	Head office function with the provision of high value functions and managing risk.
Fastlight Ltd	Provides low value services to associated enterprises. Contract manufacturing for associated enterprise.	Service provider (limited risk) Contract manufacturer (limited risk)
Nugget Ltd	Sale of conveyor belts.	Distributor
	Consulting services (not material income)	Service provider (ancillary business given 10% of income)

Part 3

The 2017 OECD Guidelines define "Comparability analysis" as a comparison of a controlled transaction with an uncontrolled transaction. Controlled and uncontrolled transactions are comparable if one of the differences between the transactions could materially affect the factor being examined in the methodology (e.g. price or margin), or if reasonably accurate adjustments can be made to eliminate the materials effects of any such differences.

A core concept of the arm's length principle is an analysis between controlled (within an MNE group) and uncontrolled (independent) transactions. This is referred to as a "comparability analysis" and is at the heart of the application of the arm's length principle (1.7 of OECD Guidelines).

Students which have responded comprehensively will make some reference to general guidance on comparability from contained in Section D of Chapter 1 of the OECD Guidelines.

Article 9 of the OECD Model Tax Convention is the foundation for comparability analyses as it introduces a need for:

- A comparison between conditions (including prices, but not only prices) made or imposed between associated enterprises and those which would be made between independent enterprises, in order to determine whether a re-writing of the accounts for the purposes of calculating tax liabilities of associated enterprises is authorised under Article 9 of the OECD Model Tax Convention; and

- A determination of the profits which would have accrued at arm's length, in order to determine the quantum of any re-writing of accounts.

There are two key aspects in an analysis (1.33 of OECD Guidelines).

Firstly, to identify the commercial or financial relations between the associated enterprises and the conditions and economically relevant circumstances attaching to those relations in order that the controlled transaction is accurately delineated.

The second aspect is to compare the conditions and the economically relevant circumstances of the controlled transaction as accurately delineated with the conditions and the economically relevant circumstances of comparable transactions between independent enterprises.

The typical process of identifying the commercial or financial relations between the associated enterprises and the conditions and economically relevant circumstances attaching to those relations requires a broad-based understanding of the industry sector in which the MNE group operates and of the factors affecting the performance of any business operating in that sector. This is derived from an overview of the MNE group which outlines how the MNE group responds to the factors affecting performance in the sector, including its business strategies, markets, products, its supply chain, and the key functions performed, material assets used, and important risks assumed. This information is likely to be included in the Country by Country master file (1.34 of OECD Guidelines).

The economically relevant characteristics or comparability factors that need to be identified in the commercial or financial relations between the associated enterprises in order to accurately delineate the transaction are:

- The contractual terms of the transaction (D.1.1).

- The functions performed by each of the parties to the transaction, taking into account assets used and risks assumed, including how those functions related to the wider generation of value by the MNE group to which the parties belong, the circumstances surrounding the transaction, and industry practices (D.1.2).

- The characteristics of property transferred or services provided (D.1.3).

- The economic circumstances of the parties and of the market in which the parties operate (D.1.4).

- The business strategies pursued by the parties (D.1.5).

Part A of Chapter III of the OECD Guidelines sets out how to perform a comparability analysis.

The comparison examines the controlled transaction under review and the uncontrolled transaction that are regarded as potentially comparable. The search of comparable is only part of the comparability analysis. The steps outlined in Section D.1 are relevant and should be considered prior to undertaking a search for information on potentially comparable uncontrolled transactions. This includes the economically relevant characteristics or comparability factors. Otherwise, it will be difficult to identify what transactions you seeking to comparable for.

A methodical, consistent approach should provide some continuity or linkage in the whole analytical process, thereby maintaining a constant relationship amounts the various steps – from the preliminary analysis to selection of the TP method, throughout to the identification of potential comparable and ultimately whether the controlled transactions are arm's length in terms of the outcome (3.1 of OECD Guidelines).

The comparability analysis aims to find the most reliable comparable so that the most appropriate transfer pricing method can be applied. Therefore, uncontrolled transactions with a less degree of comparability should be eliminated. It is acknowledged that there are practical challenges with obtaining reliable information. Further, an exhaustive search of all possible comparables does not need to be undertaken. (3.2 of OECD Guidelines)

It is best practice for taxpayers and tax administrations to use comparables and supporting information to support its transfer pricing position. This includes the selection process undertaken, the reasons for the selection and rejection of certain comparables and data to support the analysis. (3.3 of OECD Guidelines)

A.1 of the OECD Guidelines provides best practice on the typical process to follow when conducting a comparability analysis. It is acknowledged that the reliability of the outcome is more important than the process undertaken. The steps of the process, as documented in 3.4 of the OECD Guidelines are as follows:

1. Determine the years to be covered.

2. Broad-based analysis of the taxpayer's circumstances. (Refer to A.2)

3. Understanding the controlled transactions under examination, based on a functional analysis, in order to choose the tested party, the most appropriate transfer pricing method, the financial indicator that will be tested (for transactional profit method), and identify the significant comparability factors (Refer to A.3).

4. Review of existing internal comparables, if any (Refer to A.4.2).

5. Determine available sources of information on external comparables (Refer to A.4.3)

6. Selection of most appropriate transfer pricing method, and determination of relevant financial indicator (Refer to Chapter II).

7. Identification of potential comparables: determine key characteristics to be met by any uncontrolled transaction in order to be regarded as potentially comparable, based on the relevant factors in Step 3 and in accordance with comparability factors in Section D.1 of Chapter 1 (Refer to A.5).

8. Determination of and making comparability adjustments where appropriate (Refer A.6).

9. Interpretation and use of data collected, determination of the arm's length remuneration (Refer to A.7).

It is acknowledged that practically, the above process is not linear.

The better students will refer to the OECD Guidelines to provide further context regarding the individual steps (references in brackets above).

PART B

Question 3

Students should frame the functions, assets and risks of the Sweet Tooth group with reference to the OECD Transfer Pricing Guidelines 2017, Chapter I, D.1.2. A functional analysis should identify the economically significant activities and responsibilities undertaken, assets used or contributed, and risks assumed by the parties to the transactions. Each entity concerned should be characterised following identification of the functions, assets and risks of the entities pre and post restructuring. Consideration should be given to the commercial rationale of the business restructure itself and the arm's length principle.

ST Corp (Country C)

Pre-restructure:

- Fully fledged manufacturer with legal and economic intellectual property ownership and a research and development function.
- Assets utilised - plant and equipment (factory), human capital, inventory, working capital, intellectual property.
- Manages and controls all associated risks.

Post restructure:

- Remains a fully-fledged manufacturer but without research and development or legal intellectual property (and economic? to be questioned based on substance of DEMPE functions) ownership.
- Assets utilised remain except IP transferred to Subsidiary Y.
- Manages and controls all associated risks except with regard to intellectual property (substance to be tested) and the addition of financing risks and potential foreign exchange risk.
- Financing extended via a loan to Subsidiary X.
- Research and development function transferred to Subsidiary X.
- Royalty paid to Subsidiary Y for use of intellectual property.

Subsidiary X

Pre restructure:

- Non-existent.

Post restructure:

- Fully fledged manufacturer or contract manufacturer.
- Assets utilised - plant and equipment (factory), human capital, inventory, working capital.
- Manages and controls all associated risks.
- Research and development function.

- Receipt of loan from ST Corp.

- Payment of royalty to Subsidiary Y for use of intellectual property.

<u>Subsidiary Y</u>

Pre restructure:

- Non-existent.

Post restructure:

- Intellectual property hub (economic substance to be tested under DEPME).

- Assets - legal and economic ownership of intellectual property (economic substance to be tested under DEMPE).

- Risks - intellectual property.

Reference is made to the OECD Transfer Pricing Guidelines (2017), Chapter IX – Transfer Pricing Aspects of Business Restructurings and the following sections: Part I Part I, Arm's length compensation for the restructuring itself and Part II, Remuneration post-restructuring controlled transactions.

Consideration of the impact of the changes to functions, assets and risks of the entities for the Sweet Tooth group by examining the pre and post business restructure to identify the arm's length nature of the overall restructure as well as the individual transactions between associated enterprises.

Having regard to OECD Transfer Pricing Guidelines (2017), Chapter IX – Transfer Pricing Aspects of Business Restructurings, Part I, B, the commercial and financial relations between the associated enterprises must be understood/analysed. Specifically:

- An accurate delineation of the transactions before and after the restructure;

- The business reasons for and expected benefits from the restructuring, including the role of synergies; and

- The other options realistically available to the parties.

A full FAR analysis would be required for all entities to establish the global value chain and economic substance of the group pre and post restructure.

Regard needs to be given to OECD Transfer Pricing Guidelines (2017), Chapter IX – Transfer Pricing Aspects of Business Restructurings, Part I, E.2, Intangibles. In particular:

- Has there been a legal and economic transfer of intellectual property?

- Which entity/entities are involved in the development, enhancement, maintenance, protection and exploitation of intangibles (DEMPE) functions and has there been any change economically?

- Has there been an arm's length compensation for the transfer of assets and risk?

- Has the transfer of intellectual property arm's length?

Other issues to consider from a transfer pricing perspective includes

- What are the contractual terms between the parties (pre and post BR)?

- Has there been documentation that demonstrates the decision making process to reallocate risk (including the details the consequence of the profit potential of significant risk allocation)? Is the economic substance in line with the reallocation of risks?

- Valuation issue in relation to the arm's length compensation for transfer of intellectual property.

- Have there been buy-out payments?

- Arm's length nature of the royalty paid.

- Arm's length remuneration for fully fledged or contract manufacturing activities?

- Loss of profit making potential.

- Exit payments due?

- Analysis of the contractual relations together with evidence of the actual conduct of the parties, including control over risks.

- Where economically relevant characteristics of a transaction are inconsistent with contractual terms, the actual transactions should in general be identified based on the actual conduct of the parties

- The legal form of the transaction relative to the economic reality of the transaction.

- An examination of operating profit allocation to the entities within Sweet Tooth group to the economic activities generating them.

Question 4

Students should reference the OECD Model Tax Convention on Income and Capital (2017), Article 5 – Permanent Establishment and the United Nations Double Taxation Convention (2017).

The facts of the situation of the Tenor group should be applied in relation to the Article 5 of the Model Tax Convention (2017). Key issues include:

- It may be argued that Velaris has a fixed place of business permanent establishment in Dunland through the operation of a potential office, branch, factory or workshop. The place of management may also be conducted in Dunland; Article 5(1 & 2).

- The installation project being undertaken in Dunland - regard is given to Article 5(3) stating lasting more than 12 months, however, the updated article and commentary has regard to circumstances where contracts and work conducted within the project may be split up. This may be the case with the Tenor group in terms of 3 to 6 month activities.

- The new anti-fragmentation rules, noting Article 5(4), may apply to the Tenor group in terms of the involvement of sub-contractors (potentially related) that results in the overall combination of activities carried out in Dunland resulting in a permanent establishment for Velaris. This includes activities that may well be preparatory or auxiliary in nature that may not be taken advantage of given the cohesive operating business overall.

- With reference to Article 5(5), notwithstanding the overall contract being signed by senior management from Velaris, further contracts or addendums under the umbrella agreement may be habitually concluded routinely in Dunland. This may constitute a dependent agent permanent establishment.

- In relation to Article 5(6), the updated independent agent permanent establishment definition may apply to the Tenor group through the operations of the sub-contractors for this project being undertaken in Dunland. This would potentially cause a dependent agent permanent establishment rather having the previous commissionaire arrangement providing an exemption.

- A services permanent establishment needs to be considered with reference to the specialist service technicians performing work on behalf of Velaris in Dunland.

Article 7 (business profits) of the OECD Model Tax Convention (2017) would have implications for the attribution of potential profits to a permanent establishment of Velaris in Dunland. Action 7 of the BEPS Action Plan mandated the development of changes to the permanent establishment definition in Article 5 (as noted above) in the OECD Model Tax Convention (2017).

Reference is made to the OECD Guidance on Attribution of Profits to Permanent Establishments (2017).

The Additional Guidance on the Attribution of Profits to Permanent Establishments, BEPS Action 7 (2018) particularly notes attribution commentary in relation to Article 5(4), 5(5) and 5(6). The analysis of the examples included in the Report is governed by the authorised OECD approach (AOA) contained in the 2010 version of Article 7. Guidance includes examples dealing with the attribution of profits to a PE relating to warehousing activities, commissionaire arrangements, an online advertising sales structure, and procurement activities. The key principle across the examples is that the profits attributable to a PE are those that the PE would have derived if it were a separate and independent enterprise having regard to the functions, assets and risks.

PART C

Question 5

Students should reference the OECD Transfer Pricing Guidelines 2017, Chapter VII – Special Considerations for Intra-Group Services; and BEPS Action Item 10 – Transfer Pricing Guidelines covering low value-adding intra-group services.

Reference is made to B.1.1 - the Benefits test. Under the arm's length principle, if an intra-group service has been rendered, whether economic or commercial value has been provided to the other group member to enhance or maintain its business position and therefore, whether an independent enterprise would be willing to pay for the activity if performed in-house for itself.

Chargeable intra-group services could include:

- Administrative services (planning, accounting, auditing, budgetary control, legal, IT).
- Manufacturing and production.
- Insurance and reinsurance.
- Financial services (cash flows, loans, etc).
- Assistance in production, buying, distribution & marketing.
- Information technology.
- Staff services (recruitment, training).
- Research and development.

The cost of providing such services may be borne initially by the parent, by a specially designated group member ("a group service centre"), or by another group member. The charge for intra-group services should be that which would have been made and accepted between independent enterprises in comparable circumstances.

Non-chargeable intra-group services may include:

Shareholder activities: Shareholder activities are activities performed by a parent company solely because of its ownership interest. Shareholder activities do not justify a charge to recipient companies.

Duplicative activities. If services performed by a group member or by a third party are duplicated, this is not normally a provision of services unless temporary duplication; Duplication is to reduce risk of making a wrong business decision, e.g. obtaining a second opinion.

Activities giving rise to incidental benefits: a group member may obtain an economic benefit as a result of a transaction aimed to achieve something else, e.g. a group structural reorganization This would not normally be an intra-group service, as the activities producing the benefit would not be activities for which an independent enterprise would pay.

Benefits only because of membership of a large group: Benefits obtained solely due to being part or a large group should not constitute a service (as opposed to benefits attributable to specific activity).

Service availability 'on call': Is the availability of services itself a separate service that justifies an arm's length charge in addition to charges for services actually rendered?

With reference to B.2.2 - identifying actual arrangements for charging for intra-group services.

A direct charge (reference; B.2.2.1) is generally preferred to an indirect allocation and is required to be made where a service can be charged (both in terms of identifying the service and allocated a cost/mark-up for that service) i.e. when a MNE has the ability to demonstrate a separate basis for the charge (e.g. by recording the work done and costs expended in fulfilling its third party contracts). For example the cost of providing computers, training, legal advice, etc. for a specific entity. A direct approach is normally required where services are also rendered to third parties. Intragroup services are not different, in principle, to other intra-group transactions, so the standard arm's length principle applies.

Where a direct charge is not possible, then an indirect charge (reference; B.2.2.2) can be made and requires cost allocation and apportionment methods which often necessitate some degree of estimation or approximation. An indirect charge is the allocation of costs for a particular intra-group service based on an allocation key. (Indirect-charge method = a method of charging for intra-group services based upon cost allocation).

When the calculation of a direct charge may be too difficult due to administrative burden or complicated processes. An indirect charge or allocation is relevant where the value of services rendered cannot be quantified – e.g. sales promotion activities performed centrally affecting sales for many affiliates; or separate recording of costs related to each beneficiary would involve an administrative burden that would be disproportionately heavy. Indirect charges normally apply to the vast majority of charges made by MNEs. Any indirect charge method should be sensitive to the commercial features of the individual case (e.g. the allocation key makes sense under the circumstances), contain safeguards against manipulation and follow sound accounting principles, and be capable of producing charges or allocations of costs that are commensurate with the actual or reasonably expected benefits to the recipient of the service.
Allocation keys may include: turnover; number of entities; number of staff; number of computers; employee hours.

Reference is made to Section D - Low value-adding intra-group services. This discusses services which are supportive in nature, not part of the core business of the MNE group, do not require the use of unique and valuable intangibles and do not lead to the creation of unique and valuable intangibles; and do not involve the assumption or control of substantial risk by the service provider. The profit mark-up for low value-adding intra-group services applicable to all costs in the pool, except pass-through costs, shall be equal to 5% of the relevant costs. This is pragmatic approach that does not require support from a benchmarking study (reference D.2.4).

<u>Question 6</u>

Students should reference Chapter V of the OECD Transfer Pricing Guidelines 2017 - Documentation. This provides guidance for rules and/or procedures on documentation in connection with a transfer pricing enquiry or risk assessment and is therefore highly relevant to the advice to provide as a transfer pricing consultant. This will ensure that the client will give consideration to transfer pricing requirements in establishing prices and other conditions for transactions between associated enterprises and in reporting the income derived from such transactions in the tax returns. It will also be useful in substantiating transfer pricing positions taken in complying with the arm's length principle in the event of a transfer pricing enquiry by tax administrations.

Well prepared, contemporaneous transfer pricing documentation therefore highly beneficial for the client from a risk management perspective in terms of:

- Demonstrating the arm's length nature of transactions and arrangements between associated enterprises including the commercial rationale;

- Preventing future compliance costs and time associated with transfer pricing reviews and particularly audits;

- Preventing the cost and reputational issues in connection with transfer pricing adjustments by tax authorities (in multiple jurisdictions) including reduction in penalties;

- Reduction in the risk of double taxation;

- Ease of annual review of the transfer pricing documentation;

- Overall provision of assurance to taxation authorities of transfer pricing policies and practices for a multinational group of companies, thereby demonstrating a culture of solid tax governance.

Reference is made to section C - A three-tiered approach to transfer pricing documentation.

1. Master File - should provide an overview of the MNE group business, including the nature of its global business operations, its overall transfer pricing policies, and its global allocation of income and economic activity. Relevant information includes organisation structure, business description, intangibles, intercompany financial activities and financial and tax positions.

2. Local File - provides more detailed information relating to specific intercompany transactions. It supplements the master file and helps meet the objective that the taxpayer has complied with the arm's length principle in its material transfer pricing positions affecting a specific jurisdiction. Such information may include relevant financial information regarding specific transactions, a comparability analysis and selection of the most appropriate transfer pricing method.

3. Country-by-Country Report - requires aggregate tax jurisdiction-wide information relating to the global allocation of the income, the taxes paid, and certain indicators of the location of economic activity among tax jurisdictions in which the MNE group operates. It may be used for high level assessment purposes and by tax administrations in evaluating other BEPS related risks.

Question 7

Reference is made to section D.3. of the OECD Transfer Pricing Guidelines 2017. Whilst an entity realising tax losses may certainly raise a higher level of attention from tax authorities, transfer pricing issues may not the cause. That is, the losses were generated from genuine commercial/economic reasons. It is noted that independent enterprises indeed can suffer sustained, genuine losses from start-up costs, unfavourable economic conditions, inefficiencies or other legitimate business reasons. However, an independent enterprise would not expect to be prepared to tolerate losses that continue indefinitely and would cease to undertake business on such terms in the longer term.

A market penetration strategy for a reasonable period may see an enterprise set lower prices in a market to gain market share and introduce new products or services relative to competitors. This would only be expected to be for a limited period of time however.

If an enterprise is incurring losses consistently whilst other associated enterprises within the MNE group are profitable may suggest a transfer pricing issue. Some product lines may be sold at a loss to push the product/brand into the market, as directed by the parent company. An independent enterprise would expect compensation in this regard.

Reference is made to section D.5. of the OECD Transfer Pricing Guidelines 2017. The arm's length principle may, at a broad level, be compared to the value attributable to goods imported by associated enterprises and the value for similar goods imported by independent enterprises. Therefore, this may be useful in analysing the arm's length character of a controlled transaction transfer price and vice versa. It is noted that valuation methods for customs purposes however, may not be aligned with the OECD's recognised transfer pricing methods.

A difficulty of this comparison/analysis is that independent enterprises would potentially not enter into a transaction in which payments were blocked, i.e. the risk of non-payment for products or services rendered. Given independent enterprises might not engage in transactions subject to government interventions, it is ambiguous as to how the arm's length principle should apply.

Question 8

Part 1

The OECD Guidelines define an advance pricing arrangement (APA) as "An arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (e.g. method, comparables and appropriate adjustments thereto, critical assumptions as to future events) for the determination of the transfer pricing of those transactions over a fixed period of time. An APA may be unilateral involving one tax administration and a taxpayer or multilateral involving the agreement of two or more tax administrations.

An APA programme can assist taxpayers by eliminating uncertainty through enhancing the predictability of tax treatment in international transactions.

Part F of Chapter IV of the OECD guidelines cover APAs. There are benefits and disadvantages (F.3 of OECD Guidelines) of entering into an APA and the different types of APAs.

The types of APAs are:

- Unilateral;
- Bilateral; and
- Multilateral.

A bilateral or multilateral APA substantially reduce or eliminate the possibility of juridical or economic double or non-taxation since all the relevant countries participate. A unilateral APA does not provide certainty in the reduction of double taxation as tax administrations affected by the transactions covered by the APA may consider that the methodology adopted does not give a result consistent with the arm's length principle (4.156 of OECD Guidelines).

Unilateral APAs may present problems for tax administrations and taxpayers. A tax administration which from the other side of the controlled transaction may disagree with the conclusion reached by the tax administration which agreed to the unilateral APA. Therefore, this may not lead to an increased level of certainly for the taxpayer.

Whether an MNE enters into an APA and the type of APA will depend on a number of factors, with some including:

- Whether the tax administrations have an APA program;
- Whether countries in which the MNE operates have tax treaties with other countries;
- Whether safe harbours apply in countries in which the MNE operates;
- The risk appetite of the MNE;
- The materiality and complexity of controlled transactions;
- The amount of resources available to the MNE;
- Whether the MNE has previously had an APA; and
- The likely position of other tax administrations in which the MNE operates (whether there has previously been transfer pricing adjustments or litigation).

Consistent with Paragraph 4.141 of the OECD Guidelines, some countries will not grant unilateral APAs. a bilateral or multilateral approach is more likely to ensure that the risk of double taxation will be reduced.

It is also noted that BEPS Action Item 14 has made changes to ensure the timely, effective and efficient resolution of treaty related disputes between tax administrations including implementing APA programmes.

Part 2

Refer to Chapter C of Chapter IV of the OECD Guidelines.

Paragraph 5 of Article 25 was incorporated in the OECD Model Tax Convention in 2008. It provides that competent authorities who are unable to reach agreement under mutual agreement procedure cases of the initiation of the case will be resolved under arbitration.

However, where a bilateral treaty does not contain an arbitration provision similar to paragraph 5 of Article 25, the competent authorities are not obliged to reach an agreement to resolve the dispute.

The taxpayer must request the arbitration. Further, the decision of arbitration must be accepted by the tax administrations and reflected in the mutual agreement decision.

Therefore, tax administrations will likely reduce the amount of time to reach agreement in executing a bilateral or multilateral APA.

<u>Part 3</u>

Part E of Chapter IV of the OECD guidelines covers safe harbours.

It is acknowledged that the arm's principle can be a resource intensive process. It imposes significant administration burden on MNE's and tax administration through complex rules and compliance burden.

Safe harbour rules have been adopted by some tax administrations and have been applied by small taxpayers and for less complex transactions. They can be beneficial for MNE's and tax administrations for low risk transfer pricing risks and when adopted on a multilateral or bilateral basis.

Safe harbours can also benefit tax administrations by not allocating scarce resources to low risk, small taxpayers or less complex transactions.

The better students will list and explain both the benefits and concerns over safe harbours.

The main benefits of safe harbours are:

- Simplifying compliance and reducing compliance costs for eligible taxpayers.
- Providing certainty to eligible taxpayers that the price charged or paid on qualifying controlled transactions will be accepted by tax administrations will be accepted by the tax administration.
- Permit tax administrations to redirect their resources to more complex or higher risk transactions.

Concerns over safe harbours include:

- May lead to taxable income not being consistent with the arm's length principle in the country which provided the safe harbour.
- Safe harbours may increase the risk of double taxation when adopted unilaterally.
- May open up opportunities for inappropriate tax planning.
- May raise issues of equality and uniformity.

Question 9

Part 1

The arm's length principle is defined by the OECD Guidelines as "the international standard that OECD member countries have agreed should be used for determining transfer prices for tax purposes." It is set forth in Article 9 of the OECD Model Tax Convention as follows: where "conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly".

A major reason why OECD member countries and other countries have adopted the ALP is this provides broad parity of tax treatment for members of MNE groups and independent enterprises. This puts associated and independent enterprises on a more equal footing for tax purposes and avoids the creation of tax advantages or disadvantages. This promotes the growth of international trade and investment. (1.8 of OECD Guidelines)

However, it is widely acknowledged that there are practical difficulties in applying the arm's length principle. For example, associated enterprises may engage in transactions that independent enterprises do not undertake. Such transactions may not necessarily be motivated by tax avoidance, but MNE groups may face different commercial circumstances than would independent enterprises. The arm's length principle is challenging to apply in these instances where independent enterprises do not enter into such transactions. There is little or no direct evidence of what conditions would have been established by independent enterprises. The mere fact that a transaction may not be found between independent parties does not of itself mean that it is not arm's length (1.11 of Guidelines).

There may be difficulty in obtaining adequate information to apply the arm's length principle. Because the arm's length principle usually requires taxpayers and tax administrations to evaluate uncontrolled transactions and the business activities of independent enterprises, and to compare these with the transactions and activities of associate enterprises, it can demand a substantial amount of data. The information may be incomplete and difficult to interpret, along with analysis being resource intensive. Confidentiality concerns may limit the independent data which is obtainable in the public domain. Further, certain industries may have a high level of vertical integration with non-aggregated data not obtainable. Therefore, reliable data for comparability purposes may not be obtainable.

Part 2

Explain why a multinational group may enter into a cost contribution arrangement and how the arm's length principle applies to such arrangements. (7)

Chapter VIII of the OECD Guidelines covers cost contribution arrangements (CCA).

A CCA is defined as a contractual arrangement among business enterprises to share the contributions and risks involved in the joint development, production or the obtaining of intangibles, trade assets or services with the understanding that such intangibles, tangible assets or services are expected to create benefits for the individual businesses of each of the participants.

A CCA does not require the participants to combine their operations in order to exploit the outcome from the CCA or to share the profits or revenue. However, participants exploit their interest in the outcomes of the CCA through their individual businesses. The transfer pricing issue focus on the commercial or financial relations between the CCA participants and their contributions made.

A key feature of a CCA is the sharing of contributions. Consistent with the arm's length principle, at the time of entering into a CCA, each participant's proportionate share of the overall contribution to a CCA must be consistent with its proportionate share of the overall expected benefits under the arrangement.

Better candidates will make reference to research and development, value of participants' contribution, balancing payments, entry, exit and termination of CCAs.