THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

June 2021

MODULE 3.03 – TRANSFER PRICING OPTION

SUGGESTED SOLUTIONS

PART A

Question 1

Part 1

The 2017 OECD Transfer Pricing Guidelines (TPG) define an associate enterprise as:

"two enterprises are associated enterprises with respect to each other if one of the enterprises meets the conditions of Article 9, sub-paragraphs 1a) or 1b) of the OECD Model Tax Convention with respect to the other enterprise."

Article 9 states where:

"a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State."

Based on the facts, the following transactions are between associated enterprises of the Beagle Group:

Subsidiary	Details
Country A	• Provides intellectual property to Country B, Country C and Country D. • Provision of finance (loans) to Country B, Country C and Country D. • Provision of services (management, administration, information technology, marketing and technical assistance) to Country B, Country C and Country D. • Sale of finished products to Country B, Country C and Country D. • Contract manufacturing with Country C for manufacture of finish product. • Contract research and development with Country C.
Country B	• Use of intellectual property from Country A (unsure if utilise all IP). • Receipt of finance (loans) from Country A. • Receipt of intellectual property from Country A. • Receipt of services from Country A. • Purchase of finished goods from Country A (assumed that goods manufacture by Country C that title to goods is held by Country A).
Country C	• Use of intellectual property from Country A. • Receipt of finance (loans) from Country A. • Receipt of intellectual property from Country A. • Receipt of services from Country A. • Purchase of finished goods from Country A (assumed that goods manufactured by Country C that title is held by Country A). • Undertakes contract manufacturing for Country A. • Undertakes contract research for Country A.
Country D	• Use of intellectual property from Country A. • Receipt of finance (loans) from Country A. • Receipt of intellectual property from Country A. • Receipt of services from Country A. • Purchase of finished goods from Country A (assumed that goods manufactured by Country C that title is held by Country A).

Part 2

Candidates are expected to indicate knowledge of the 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) used. They should analyse and indicate which one (or ones) is the 'most appropriate' in the circumstances. 'The selection of a transfer pricing method always aims at finding the most appropriate method for a particular case' (Refer to the 2017 TPG at [2.2]). The most suitable method is based on the specific facts and circumstances which are limited in this case.

Comparable uncontrolled price method (CUP)

The CUP method compares the price charged for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances. If there is any difference between the two prices, this may indicate that the conditions of the commercial and financial relations of the associated enterprises are not arm's length, and that the price in the uncontrolled transaction may need to be substituted for the price in the controlled transaction.

A CUP method is particularly reliable where an independent enterprise sells the same product as is sold between two associated enterprises. However, it does require a high degree of comparability.

For the Beagle Group, there is a potential internal CUP for determine the arm's length remuneration for the manufacturing by Country C on behalf of Country A. This is based on the contract between Country A and the third party manufacturer where 40% of the group's products are sourced.

Further, there is potentially a comparable for the funds loaned by Country A to Country B, Country C and Country D based on the interest rate paid by Country A to the independent bank.

Resale price method

The resale price method begins with the price at which a product has been purchased from an associated enterprise and the product is resold to an independent enterprise. This price (the resale price) is then reduced by an appropriate gross margin on this price (the "resale price margin") representing the amount out of which the reseller would seek to cover selling and other operating expenses, and in light of the functions performed (taking into account the assets used and risks assumed), make an appropriate profit.

What is left after subtracting the gross margin can be regarded, after adjustment for other costs associated with the purchase of the product (e.g. customs duties), as an arm's length price for the original transfer of property between the associated enterprises. This method is probably most useful where it is applied to marketing operations.

The resale margin of the reseller in the controlled transaction may be determined by reference to the resale price margin that the same reseller earns on items purchased and sold in comparable uncontrolled transactions ("internal comparable"). Also, the resale price margin earned by an independent enterprise in comparable uncontrolled transactions may serve as a guide ("external comparable").

Resale price method is difficult to apply in terms of gaining gross margin data and also requires no alteration to the product resold.

For the Beagle Group, the resale price method may not be applied based on the facts provided.

Cost plus method

The cost plus method begins with the cost incurred by the supplier of property (or services) in a controlled transaction for property transferred or services provided to an associated purchaser. An appropriate cost plus mark-up is then added to this cost, to make an appropriate profit in light of the functions performed and the market conditions. What is arrived at after adding the cost plus mark up to the above costs may be regarded as an arm's length price of the original controlled transaction. This method probably is most useful where semi-finished goods are sold between associated parties, where associated parties have concluded joint facility agreements or long-term buy-and-supply arrangements, or where the controlled transaction is the provision of services.

The Beagle Group appears to operate based on a centralised operating model (refer to B.1.5 of TPG) with Country A undertaking a number of services on behalf of associated enterprises. For these services, it may be remunerated on a cost plus basis, applying a an arm's length margin to the cost base of chargeable services for the provision of services (management, administration, information technology, marketing and technical assistance). Alternatively, a TNMM may also be applied with a cost plus.

Based on paragraph 7.61 of TPG - the arm's length charge for low value-adding intra-group services shall apply a profit mark-up to all costs in the pool with the exception of pass through costs (refer to paragraphs 2.99 and 7.34). The mark-up should be 5% of the relevant costs, determined consistent with section D.2.2. No benchmarking is required to be undertaken in support of the 5% markup.

Section D of TPG covers low value services which are of a supportive nature, are not considered to be part of the MNE's core business, do not require the use of unique and valuable intangibles and do not involve the assumption or control of significant risk by the service provider. Paragraph 7.47 sets out activities which do not qualify for the simplified approach. Further, paragraph 7.45 provides examples which are likely to meet the definition of a low value service including a number which are of the type undertaken by Country A and Country C.

Further, as Country C undertakes contract manufacturing and contract research and development on behalf of Country A, it may be remunerated using a cost plus method.

<u>Transactional net margin method (TNMM)</u>

The 'TNMM' examines the net profit relative to an appropriate base (e.g. costs, sales, assets) that a taxpayer realises from a controlled transaction. Thus, 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 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 the associated enterprises (the tested party) which is a benefit when one of the entities 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.

Refer to section B.3.2 for further detail on selection of the net profit indicator.

A TNMM may be applied to the entities in the Beagle Group, including Country B, Country C and Country D in relation to their distribution activities/functions (sales, marketing and associated activities) if potential comparables are identified. An appropriate Profit Level Indicate may be EBIT/Sales margin, possibly in the range of 2-5%, but this is subject to a functional analysis and benchmarking exercise to be undertaken.

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.

Approaches for profit split – contribution analysis (refer to section C.3.2.1) and residual analysis (refer to section C.3.2.2).

In relation to the Beagle Group, it is unlikely that the profit split method is appropriate based on the facts provided as only one party is contributing the intellectual property.

The 2017 TPG at 6.205 indicates 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."

In relation to the utilisation of IP which is legally owned by Country A, further information would need to be obtained. However, it is likely that subsidiaries should not be charged as Country A is undertaking the DEMPE functions per para 6.3 of TPG and should be entitled to retain the profits from exploiting the IP.

Part 3

It should be noted that the commercial and financial relations should be identified between associated enterprises and the conditions and economically functional circumstances considered. Refer to Chapter 1, D.1 of TPG.

A functional analysis should also be undertaken in order to delineate the controlled transaction and determine comparability between controlled and uncontrolled transactions.

An audit should not be undertaken by the tax administration solely based on information contained on Country by Country documentation, which will assist with risk assessment purposes.

The tax administration of Country A is likely to be concerned with the operating margins of Country A (2%) in comparison with associated enterprises in the group. Despite Country A owning the group's IP and undertaking the majority of the value adding activities and economic functions, its margins are the lowest in the group. Beagle may have undertaken tax planning with the higher tax rate in Country A compared to the other countries in which it operates. It appears that the arm's length principle may not be appropriately applied in the Beagle group.

The 2017 TPG (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 Country B, C and D are undertaking more routine or lower risk activities relating to sales and distribution activities. Subject to benchmarking, an operating margin of 2-5% may be expected. In relation to Country C, a cost plus no more than 5% to 7.5% would likely be expected for the cost research and development and contract manufacturing activities on behalf of Country A.

Country D has a limited number of staff and makes online sales to customers where Beagle Group doesn't have a physical presence (i.e. a subsidiary or staff undertaking sales and marketing activities). A functional analysis should be undertaken, but this entity may not be undertaking significant functions and is likely to be earning a profit margin not in commensurate with its economic activity and functions, assets and risks.

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 (DEMPE). Members of the MNE group should be compensated for their contribution under the arm's length principle.

Based on the facts provided, only Country A is undertaking the DEMPE functions.

An additional risk is that Country A may not have be receiving arm's length compensation for providing services to associated enterprises.

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 Beagle Group, reference is made to the 2017 OECD TPG, specifically Chapter 1, D1.2.

The steps to be undertaken are contained in D.1.2.1 - Analysis of risks in commercial or financial relations include:

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 activities each of the associate entities undertakes 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 TPG).

A functional analysis and confirm that the legal form (contracts or agreements) correlate with the economic substance of the transactions in the value chain. The CbC Master File will assist tax authorities review the global value chain and provide functional analysis information, while Local Files are accessed for country specific detail. In addition, where multilateral agreements are in force, Country-by-Country documentation is exchanged between tax administration to provide financial data, including comparative profit, economic reporting, economic activity and employee numbers in countries.

An accurate delineation based on the facts would trace the economically significant activities outlined in the facts and conclude that Country B, Country C and Country D, as separately located subsidiaries of the Beagle Group, are all conducting similar activities of distributing dog food as part of the Beagle global value chain. The group has centralised support functions performed by the parent (Country A). The three subsidiaries all have similar risk exposures and asset profile. However, Country C undertakes additional activities including limited risk contract manufacturing and research and development for Country A.

A practical functional analysis will involve conducting functional interviews with personnel across all areas of the business, including the operational level. Questions will be aimed at understanding how the various business divisions interact within the company onshore and offshore. The roles and responsibilities of the personnel will be understood as well as decision making, communication, business strategy and risks borne. The global value chain is required to be understood and the interaction of the various entities within it. The value created by each of the entities is important as well as the legal rights and obligations of each of the parties in performing the functions. The functional analysis seeks to identify the economically significant activities and responsibilities undertaken, assets used or contributed, and risks assumed by the parties to the transactions. The analysis focuses on what the parties actually do and the capabilities they provide.

<u>Part 2</u>

Limited information has been provided in the facts. However, a sample function analysis based on the information currently available:

Entity	Functions	Assets	Risks	Characterisation
Country A (Parent)	Development, maintenance and protection of intellectual property Provision of administrative and associated services (management, administration, information technology, marketing and technical	Intellectual property (brand names, trademarks, patents, manufacturing technology and knowhow Human capital Office and related equipment	Market risk Credit risk Product liability (warranty) Inventory Foreign exchange	Entrepreneur, exploitation of IP Service provider to associated enterprises

	assistance) to associates Sales and marketing activities	(computers, chairs, desk, tables) Motor vehicles		
Country B	Sales and marketing activities	Office and related equipment Human capital Motor vehicles	Inventory Market	Low risk distributor
Country C	Contract research & development Contract manufacturing Logistics Sales and marketing activities	Human capital Office and related equipment Building, plant and equipment Motor vehicles	Inventory Market	Low risk distributor Contract provider (service provider to associate)
Country D	Invoicing Logistics	Human capital Office and related equipment Motor vehicles	Inventory Market	Low risk distributor

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).

Candidates 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 TPG).

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 TPG 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 transfer pricing 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 TPG).

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 TPG).

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 TPG).

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, this process is not linear.

Part B

Question 3

Part 1

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 should be characterised following identification of the functions, assets and risks of the entities (OECD Transfer Pricing Guidelines 2017, Chapter 1, D.1.2). Industry knowledge is another important element in understanding the business and global value chain.

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.

Consideration should also be given to Section D.1. – Identifying the commercial or financial relations (CFRs). Some key points from paragraphs 1.33 to 1.41 include:

- Identify the CFRs between the associated enterprises and the conditions and economically relevant circumstances attaching to those relations in order that the relevant circumstances attaching to those relations in order that the controlled transaction is accurately delineated; and to compare those conditions with those of comparable transactions between independent enterprises.

- Requires understanding of the relevant industry.

- Consider options realistically available.

With reference to Section D.1.1 – The contractual terms of the transaction, contractual terms of the associated transactions would need to be examined and compared to the substance of the arrangement.

Functional interviews should be conducted with a broad range of personnel of the associated enterprises as part of a functional analysis, this includes personnel at not only the strategic but operational levels across various business divisions.

A review of relevant transfer pricing documentation should be conducted as part of a functional analysis (refer to the OECD Transfer Pricing Guidelines, Chapter V: Documentation), including taxpayer prepare transfer pricing documentation to demonstrate the arm’s length nature of the associated transactions and the three-tiers of documentation available: master file, local file and country-by-country reports.

Reference is made to the OECD Transfer Pricing Guidelines (2017), Chapter IX – Transfer Pricing Aspects of Business Restructurings.

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.

Consideration of the impact of the changes to functions, assets and risks of the entities for the HeartHealth 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.

Pre Restructure:

Associated Entity within the MNE group	Functions	Assets	Risks	Characterisation
HH Headco	Manufacturing Inventory management Demand planning Procurement (raw materials) Sales/marketing Distribution Strategy development Supplier selection Research & Development	Intellectual property Plant & equipment Warehouses Staff	Market risk Manufacturing risk Financing risk Credit risk Inventory risk Capital investment risk Warranty risk Research and development risk Intellectual property risk	Fully-fledged manufacturer / entrepreneur
HH Sub 1	Sales/marketing Procurement Demand planning Training	Warehouse Staff	Market risk	Limited risk distributor
HH Sub 2	Sales/marketing Procurement Demand planning Training	Warehouse Staff	Market risk Warranty risk	Limited risk distributor

Post Restructure – the inclusion of the following associated entities into the HeartHealth group:

HH Sub 3	Contract manufacturing Research and development Administrative services	Staff Office Plant and equipment	Manufacturing risk Inventory risk Capital investment risk Research and development risk	Contract manufacturer, Service / research and development provider
HH Sub 4	Intellectual property holding company	Staff Intellectual property	Intellectual property risk	Legal owner of intellectual property

Part 2

Reference is made to the OECD Transfer Pricing Guidelines (2017), Chapter II: Transfer Pricing Methods.

Part II of Chapter II of the OECD Transfer Pricing Guidelines (2017) lists the traditional transaction methods.

Comparable uncontrolled price method

- The CUP method compares the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances.
- Most direct and reliable way to apply the arm's length principle.
- Requires the same or very similar functionality products.
- Useful for commodities and financial transactions.

A CUP method could potentially be applied, comparing the prices of finished products sold by HH Headco (Country A) to HH Sub 1 (Country B) and the prices of finished products sold by HH Headco (Country A) to HH Sub 2 (Country C).

The sale price is the tested transaction from the perspective of the related party sales (sold by HH Headco), whilst the purchase price (paid by HH Sub 1 and HH Sub 2) are the tested transactions from the perspective of the related party purchases.

Para 1.36 of the OECD Transfer Pricing Guidelines (2017) outlines the comparability factors as:

1. Contractual terms.
2. Functions, assets and risks.
3. Characteristics of property or services.
4. Economic circumstances.
5. Business strategies.

The application of a potential CUP may have a comparability issue with regard to the products being sold in a different market (Country B and C in terms of the related transactions); potentially different economic circumstances.

Another potential comparability issue relates to the characteristics of the property (product differences), when comparing the prices of the products. In addition, the business strategy of the subsidiaries in the respective markets may differ (e.g. one may be engaged in a market penetration strategy). The terms of the supply agreements would also need to be compared in terms of comparability.

A CUP may also be applied to test the royalty rate (paid by associated entities to HH Sub 4) as well as potentially comparing the royalty rate paid to HH Sub 4 and previously paid by associated entities to HH Headco.

Resale price method

- The resale price method begins with the price at which a product that has been purchased from an associated enterprise is resold to an independent enterprise. This price (the resale price) is then reduced by an appropriate gross margin on this price (the resale price margin) representing the amount out of which the reseller would seek to cover its selling and other operating expenses and, in the light of the functions performed (taking into account assets used and risks assumed), make an appropriate profit. What is left after subtracting the gross margin can be regarded, after adjustment for other costs associated with the purchase of the product, as an arm's length price for the original transfer of property between independent enterprises.
- Most useful where it is applied to marketing operations.

- The resale price margin of the reseller in the controlled transaction may be determined by reference to the resale price margin that the same reseller earns on items purchased and sold in comparable uncontrolled transactions (internal comparable).

The resale price method could potentially be applied as a final product is being purchased by an associated entity and on-sold to independent parties. This is the case for HH Headco selling final products to its associated entities (HH Sub 1 and HH Sub 2) who are on-selling to independent parties. It could be possible to examine any potential transactions between HH Headco and independent entities and comparing gross margins.

The resale price margin of the reseller in the controlled transaction may be determined by reference to the resale price margin that the same reseller earns on items purchased and sold in comparable uncontrolled transactions (para 2.28 OECD TP Guidelines, 2007).

The comparability factors would need to considered in the potential application of this method. The functions assets and risks in particular are important with this method (refer to para 2.32 of the OECD TP Guidelines, 2007). HH Sub 1 bearing warranty risk may compound comparability issues, however reliable adjustments may be made.

<u>Cost plus method</u>

- The cost plus method begins with the costs incurred by the supplier of property (or services) in a controlled transaction for property transferred or services provided to an associated purchaser. An appropriate cost plus mark-up is then added to this cost, to make an appropriate profit in light of the functions performed and the market conditions. What is arrived at after adding the cost plus mark up to the above costs may be regarded as an arm's length price of the original controlled transaction.

- Useful for semi-finished goods and provision of services.

The cost plus method would be potentially applicable to compensate HH Headco and HH Sub 3 for the research and development services being performed. The margin would need to be considered in the context of the value of the research and development contributing to intellectual property improvement/creation.

A cost plus method may be applied to the intra-group services/training received by HH Sub 1 and HH Sub 2.

A cost plus method could be applied also to HH Sub 3 for its contract manufacturing function.
Consideration would need to be given to Chapter VII: Special Considerations for Intra-Group Services (OECD TP Guidelines, 2007). Ie. Has a service in fact been rendered, is there low or higher value added service being performed, establish the cost base and establish an appropriate margin to mark-up on. An appropriate set of comparable companies performing similar or the same services could be established utilising the comparability analysis guidelines in Chapter III of the OECD TP Guidelines, 2007.

<u>Transactional profit methods</u>

<u>Transactional net margin method (TNMM)</u>

- The TNMM examines the net profit relative to an appropriate base (e.g. costs, sales, assets) that a taxpayer realises from a controlled transaction.

- Less affected by transactional differences than a CUP.

- Net profit indicators more tolerant to some functional differences between the controlled and uncontrolled transactions than gross profit margins.

A TNMM may be applied to the profitability of HH Sub 1 and HH Sub 2. They would be the tested party and compared against companies (applying the comparability analysis framework in Chapter III of the OECD TP Guidelines and the comparability factors). A appropriate PLI may then be applied, e.g. EBIT/Sales (profitability) with distribution/marketing/sales functions.

<u>Transactional profit split method</u>

- Identifies the profits to be split for the associated enterprises from the controlled transactions in which the associated enterprises are engaged (the combined profits / losses). It then splits those combine profits between the associated enterprises on an economically valid basis that approximates the division of profits that would have been anticipated and reflected in an agreement made at arm's length.
- Useful for highly integrated operations for which a one-sided method would not be appropriate.
- Most appropriate where both parties to a transaction make unique valuable contributions (e.g. contribute unique intangibles) and wish to share their respective contributions.
- Contribution analysis and residual analyses can be conducted.

A profit split method could potentially be applied to HH Headco and HH Sub 3.

<u>Part 3</u>

Transfer pricing issues that may be raised by the various tax administrations in the respective jurisdictions of the HeartHealth group:

- Is the purchase/sale price of the final products purchased/sold between the associated entities arm's length?
- Is the royalty rate paid by the associated entities arm's length?
- Is the cost base correct and margin arm's length in the application of the cost plus method to the tested transactions?
- Is the application of each of the transfer pricing methods appropriate? (i.e. have they been correctly selected when considered before applying?)

In terms of the business restructure:

- Has there been an AL compensation for the transfer of assets?
- What are the contractual terms between the parties (pre and post business restructure).
- 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?
- Is the transfer of intellectual property at arm's length?
- Valuation issue in relation to the arm's length compensation for transfer of intellectual property.
- Buy-out payments?
- Loss of profit making potential.
- Commercial and economic rationale for entering into business restructure by all entities having regard to the arm's length principle.

- What options were realistically available for all entities involved in the business restructure?

- Exist payments due?

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

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 entitie/s 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?

There is wider scope for profit shifting in a BEPS context given the differences in tax rates between the associated enterprises in the jurisdictions.

Question 4

Part 1

Reference is made to article 5 (Permanent Establishment), and commentaries, of the OECD Model Tax Convention on Income and Capital (2017).

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

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

- Having regard to the sewage treatment project being undertaken in Country Z, reference is made to Article 5(3); a project lasting more than 12 months, however, the 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 Nightingale group in terms of the smaller 2 to 3 month projects being split from the larger, overall project.

- The anti-fragmentation rules, noting Article 5(4), may apply to the Nightingale group in terms of the activities undertaken by staff seconded from NG Headco in Country X to Country Z, as well as independent parties in Country Z. This may result in the overall combination of activities carried out in Country Z resulting in a permanent establishment for NG Headco. This includes activities that may 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 NG Headco (although in Country Z), further contracts or addendums under the umbrella agreement may be habitually concluded routinely in Country Z. This may constitute a dependent agent permanent establishment.

- In relation to Article 5(6), the independent agent permanent establishment definition may apply to the Nightingale group through the operations of independent parties, contributing to the project being undertaken in Country Z. 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 staff seconded from NG Headco to Country Z in performing work on behalf of NG Headco.

Part 2

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 NG Headco in Country Z. 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 also 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. Therefore all of the activities noted as being conducted for undertaking the project in Country Z by NG Headco would need to considered when allocating associated profit/loss.

PART C

Question 5

Part 1

Reference is made to Section C of the Transfer Pricing Guidelines (2017) – C.1: The mutual agreement procedure.

Paragraph 4.29 notes that the mutual agreement procedure (MAP), can be used to eliminate double taxation that could arise from a transfer pricing adjustment.

MAP is authorised by Article 25 of the OECD Model Tax Convention that sets out three different areas where MAP procedures are generally used:

- Instances of taxation not in accordance with the provisions of the Convention.
- Questions of interpretation or application of the Convention and the elimination of double taxation in cases not otherwise provided for in the Convention.
- Para 10e of the Commentary on Article 25 articulates that it is intended to be used by competent authorities in resolving not only problems of juridical double taxation but also those of economic double taxation arising from transfer pricing adjustments made pursuant to paragraph 1 of Article 9.

Pursuant to paragraph 5 of Article 25, in competent authorities cannot reach agreement within two years of the initiation of the case, it shall be resolved through an arbitration process.

Part 2

Reference is made to Section C.2. of the Transfer Pricing Guidelines (2017) – Corresponding adjustments: Paragraph 2 of Article 9.

Paragraph 4.32 notes that a corresponding adjustment, which in practice may be undertaken as a part of the MAP, can mitigate or eliminate double taxation in cases where one tax administration increases a company's taxable profits (i.e. makes a primary adjustment) as a result of applying the arm's length principle to transactions involving an associated enterprise in a second jurisdiction.

Some other relevant considerations are:

- Paragraph 2 of Article 9 specifically provides that the competent authorities shall consult each other if necessary to determine appropriate corresponding adjustments.
- MAP be used under Article 25 to consider corresponding adjustment requests.
- A corresponding adjustment may be made by a Contracting state by recalculating the profits subject to tax for the associated enterprise in that country using the relevant revised price most commonly.
- Not mandatory.
- Can be an effective means of obtaining relief from double taxation resulting from transfer pricing adjustments.
- Most OECD member countries do not recognise on the grounds that the tax return should reflect the actual transactions.

Reference is made to Section C.5 – Secondary adjustments.

Some key points are:

- Primary transfer pricing adjustments and their corresponding adjustments change the allocation of taxable profits of an MNE group for tax purposes.

- Some countries having proposed a transfer pricing adjustment will assert under domestic legislation a constructive transaction (a secondary transaction) whereby excess profits resulting from a primary adjustment are treated as having been transferred in some other form and taxed accordingly.

- Secondary adjustments usually take the form of constructive dividends, constructive equity contributions, or constructive loans.

- Attempt to account for the difference between the re-determined taxable profits and the originally booked profits.

- May serve to prevent tax avoidance.

- May result in double taxation unless a corresponding credit or some other form of relief is provided by the other country for the additional tax liability that may result from a secondary adjustment.

- Commentary on paragraph 2 of Article 9 of the OECD Model Tax Convention notes that the Article does not deal with secondary adjustments, and thus it neither forbids nor requires tax administrations to make secondary adjustments.

- Rejected by some countries because of the practical difficulties they present.

- Repatriation issues.

<u>Part 3</u>

The BEPS Action 14 Minimum Standard seeks to improve the resolution of tax-related disputes between jurisdiction. Inclusive Framework jurisdictions have committed to have their compliance with the minimum standard review and monitored by its peers through a robust peer review process that seeks to increase efficiencies and improve the timeliness of the resolution of double taxation disputes.

Many tax treaties between jurisdictions contain a MAP provision providing for a process used to resolve such disputes. Article 25 of the OECD Model Tax Convention provides a mechanism, independent from the ordinary legal remedies available under domestic law, through which the competent authorities of the Contracting States may resolve differences or difficulties regarding the interpretation or application of the Convention on a mutually-agreed basis. This mechanism – the mutual agreement procedure – is of fundamental importance to the proper application and interpretation of tax treaties, notably to ensure that taxpayers entitled to the benefits of the treaty are not subject to taxation by either of the Contracting States which is not in accordance with the terms of the treaty.

Despite the widespread existence of this provision in tax treaties, further effort is needed to ensure that access to MAP is available and that MAP cases are resolved within a reasonable timeframe and implemented quickly.

The final report on *Action 14: Making Dispute Resolution Mechanisms More Effective*, which contains a BEPS minimum standard, was adopted in October 2015. The Action 14 Minimum Standard consists of 21 elements and 12 best practices, which assess a jurisdiction's legal and administrative framework in the following four key areas:

1. Preventing disputes;
2. Availability and access to MAP;
3. Resolution of MAP cases; and

4. Implementation of MAP agreements.

Along with the adoption of this minimum standard, the BEPS Inclusive Framework members agreed on:

- A peer review process to evaluate the implementation of this standard; and
- To report MAP statistics under a newly developed reporting framework ("MAP Statistics Reporting Framework").

The Action 14 peer review process was launched at the end of 2016, with 79 jurisdictions to be reviewed over a period from 2016 to 2021. The process consists of two stages. In stage 1, jurisdictions' implementation of the Action 14 Minimum Standard is evaluated and recommendations are made where jurisdictions have to improve in order to be fully compliant with the requirements under this standard. The follow-up of the recommendations is measured in stage 2 of the process.

Question 6

Part 1

Reference is made to the OECD Transfer Pricing Guidelines (2017), Chapter IV: Administrative Approaches, Section E – Safe Harbours.

Paragraph 4.102 states that a safe harbour in a transfer pricing regime is a provision that applies to a defined category of taxpayers or transactions and that relieves eligible taxpayers from certain obligations otherwise imposed by a country's general transfer pricing rules.

Paragraph 4.105 notes the following benefits of safe harbours:

- Simplifying compliance and reducing compliance costs.
- Certainty for eligible taxpayers.
- Allocation of tax administration resources to more complex or higher risk transactions.

Section E.3.1 highlights that safe harbours may significantly ease compliance burdens whilst section E3.3 notes administrative simplicity.

Concerns over safe harbours stipulated in section E.4 include:

- The implementation of a safe harbour may lead to taxable income being reported that is not in accordance with the arm's length principle.
- May increase the risk of double taxation or double non-taxation when adopted unilaterally.
- Potential for inappropriate tax planning.
- Issues of equity and uniformity.

Recommendations noted in section E.5 include:

- Properly designed safe harbours in appropriate circumstances.
- Make safe harbours elective to taxpayers.
- Negotiate on a bilateral or multilateral basis.
- Not binding on or precedential for countries which have not themselves adopted the safe harbour.
- Not appropriate for more complex or higher risk transfer pricing matters.
- Country tax administrations should carefully consider the benefits and costs of safe harbours as they deem appropriate.

Reference is made to the OECD Transfer Pricing Guidelines (2017), Chapter IV: Administrative Approaches: a simultaneous tax examination is an "arrangement between two or more parties to examine simultaneously and independently, each on its owns territory, the tax affairs of (a) taxpayer(s) in which they have a common or related interest with a view to exchanging any relevant information which they so obtain".

Paragraph 4.79 confirms that a simultaneous tax examination is a form of mutual assistance, used in a range of International issues such as transfer pricing. It enables two or more countries to cooperate in a tax investigation, review or audit. Due to the sharing of appropriate information between tax administrations and the engagement between, they should result in a timelier resolution. They should reduce the instances of economic double taxation as an outcome between tax administrations is reached in the audit which results in minimising double taxation for the multinational group (between jurisdictions participating in the examination).

As noted at section D.2. of Chapter IV of the OECD Transfer Pricing Guidelines (2017), Article 26 of the OECD Model Tax Convention (Exchange of Information) provides the legal basis for concluding such examinations and require the involvement of competent authorities of participating jurisdictions. If an examination is undertaken at an early stage, this may limit obstacles including time limitations for margin adjustments. The early exchange of foreseeably relevant information will aid this issue. Further, a case plan should be closely followed to ensure that timeframes are adhered to including frequent meetings with taxpayers to clarify factual information. Tax administrations generally gain a better understanding and insight into the MNEs activities. They may also assist in determining taxpayer behaviour, practices and trends within an industry. The process should help tax administrations establish pertinent facts faster and. This should assist in identifying potential risks or disputes at an earlier stage, minimising the potential for litigation.

Tax administrations participating may reach an agreement on the transfer pricing conditions of transactions between associated enterprises. This may result in adjustments betting made at an earlier stage, avoiding double taxation and drawn out processes. It should provide certainty at an earlier stage for the MNE. The process may also benefit MNEs from saving of resources and time due to the co-ordination of examinations between several tax administrations.

As noted at paragraph 4.94 of the OECD Transfer Pricing Guidelines (2017), a greater use of simultaneous tax examinations is therefore recommended in the examination of transfer pricing cases and to facilitate the exchange of information and the operation of mutual agreement procedures.

<u>Part 2</u>

Reference is made to 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.

<u>Chargeable intra-group services could include:</u>

- 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 the following types of activity.

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. 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).

Question 7

Cameco Corporation [2020 FCA 112]

The Supreme Court of Canada ("SCC") recently dismissed leave to the Federal Court of Appeal's ("FCA") decision of *Her Majesty the Queen. v. Cameco Corporation*, 2020 FCA 112 [*Cameco*]. The FCA ruled in favour of the taxpayer, Cameco Corporation ("Cameco"), and rejected the Crown's broad interpretation of paragraphs 247(2)(b) and (d) of the *Income Tax Act,* RSC 1985, c. 1 (the "Act").

Although the FCA made its decision in July 2020, the decision, and the subsequent dismissal by the SCC, are essential to future interpretations of the section 247 transfer pricing regime — an area of tax law that prevents large corporations from shifting profits to low tax jurisdictions among other purposes.

Facts

Cameco and its subsidiaries make up a multinational uranium producer and supplier, with uranium mines in Saskatchewan and the U.S. and processing facilities in Ontario (*Cameco*, para 7). In 1993, Cameco negotiated an agreement to purchase uranium from a consortium of companies and designated the agreement to its Luxembourg subsidiary — Cameco Europe S.A. ("CESA"). Luxembourg is a European country known for its relatively low tax.

In 1999, CESA further entered into an agreement with Urenco, a uranium enricher, to purchase more uranium. Also in 1999, Cameco formed a subsidiary in Switzerland, another low tax jurisdiction, which was named Cameco Europe AG ("CEL"). CESA subsequently transferred its rights to purchase uranium from Urenco to CEL.

The profits at issue arose due to a sale of uranium by CEL to Cameco. CEL purchased this uranium from Urenco and Cameco years before when the price of uranium was low. The price then increased substantially, and CEL was able to realize an enormous profit.

The arrangements took place through subsidiaries in Switzerland and Luxembourg and not in Canada, where Cameco holds much of its operations. Thus, Cameco substantially minimized the tax on this profit. As a result, the Minister of National Revenue ("Minister") reassessed Cameco on two bases:

- The use of its Swiss and Luxembourgian subsidiaries constituted a sham.
- The transfer pricing regime in the Act under paragraph 247(2)(b) and (d) permitted the Minister to reallocate all profits from foreign subsidiaries of Cameco to the parent Cameco corporation in Canada.

In the Tax Court of Canada ("TCC") decision, Webb J.A., writing for the FCA, described the TCC decision as a "factual data dump," with some parts having little to no relevance. The TCC considered the Minister's two arguments relating to a sham transaction and 247(2)(b) and (d) of the Act.

Sham

The U.K. case *Snook v. London & West Riding Investments, Ltd.,* [1967] 1 All E.R. 518 defined a sham as an act or documents executed with the intention to give third parties or the Court the appearance of creating legal rights and obligations between parties which are different from what actually exists. In this case, the Minister claimed that the transactions by CESA/CEL were a sham. The Tax Court Judge disagreed.

Transfer Pricing

The main focus of the TCC decision was the application of the section 247 transfer pricing rules. The general purpose of the transfer pricing regime is to ensure transactions between non-arm's length parties are conducted in a manner that arm's length parties would accept. This prevents Canadian corporations from effectively shifting profits to a lower tax jurisdiction by selling goods or providing services to a subsidiary in another jurisdiction for an amount more or less than what arm's length parties would charge.

If an entity infringes on section 247, then the regime can adjust the taxpayers' incomes to ensure transactions between closely related parties align with how arm's length parties would have transacted.

The Tax Court judge determined that the arrangements in which CESA/CEL purchased uranium from Cameco and Urenco and in which CESA/CEL later sold back to Cameco at a higher price were not commercially irrational. Therefore, these transactions did not warrant an adjustment via section 247. CESA/CEL ultimately assumed the price risk related to its uranium inventory between the time of purchase and sale. It was therefore entitled to the upside.

Federal Court of Appeal

At the FCA, the Crown did not appeal their prior submission based on a sham transaction. Instead, they claimed the Court should "adopt a broader view of paragraphs 247(2)(b) and (d)" and that "Cameco would not have entered into any of the transactions that it did with CESA and CEL with any arm's length person." As a result, the Court should reallocate profits from CESA/CEL to the Canadian-based Cameco. The Crown further provided an alternative argument on the interpretation of paragraph 247(2)(a) of the Act.

Paragraphs 247(2)(b) and (d) Interpretation

The focus of the FCA was the competing interpretations regarding one of the conditions in paragraph 247(2)(b) of the Act (*Cameco*, para 31). If the conditions in 247(2)(b) are valid, paragraph 247(2)(d) can readjust the income of the taxpayer to what it would have been if it transacted with an arm's length person. Paragraph 247(2)(b)'s conditions are:

(b) The transaction or series
  (i) would not have been entered into between persons dealing at arm's length, and
  (ii) can reasonably be considered not to have been entered into primarily for bona fide purposes other than to obtain a tax benefit.

The issue centred on subparagraph 247(2)(b)(i). The Court question which situation was required to satisfy 247(2)(b)(i):

- Cameco and CESA/CEL dealing at arm's length would not have entered into the transaction at issue.
- No person dealing in arm's length would have entered into the transaction at issue.

The Court commenced with a textual, contextual, and purposive analysis of 247(2)(b)(i) to resolve this issue.

Textual Analysis

The FCA reasoned that the requirement in subparagraph 247(2)(b)(i) was an objective test with a hypothetical person, such as whether persons dealing at arm's length would have entered into the transaction or series of transactions. It is not a subjective test, such as whether *the particular taxpayer* (Cameco) would have entered into the transaction or series of transactions at issue with an arm's length party (*Cameco*, para 43). The Crown submitted that the subjective test was the proper interpretation of subparagraph 247(2)(b)(i).

The FCA supported this reasoning by analyzing paragraph 247(2)(d), which requires the Court to replace an offensive transaction or series of transactions with what arm's length parties would have entered into. 247(2)(d), therefore, requires replacing the transaction with what a hypothetical person would do and not the particular taxpayer in question would do. This interpretation of 247(2)(d) ultimately supported an interpretation that 247(2)(b)(i) is an objective test focused on a hypothetical person.

Contextual and Purposive Analysis

To interpret paragraphs 247(2)(b) and (d) in a contextual and purposive approach, the Court looked at the heading of section 247. The fact "Transfer Pricing" headed section 247 and "Transfer Pricing Adjustment" headed subsection 247(2) supported a 247(2)(b) and (d) interpretation that would result "in an adjustment in the pricing of the relevant transactions, rather than an interpretation that would allow the Minister to pierce the corporate veil of CEL and reallocate all of its profits to Cameco". Therefore, this contextual and purposive interpretation did not align with the Crown's interpretation which wanted to pierce the veil on Cameco's Swiss and Luxembourgian subsidiaries and reallocate their profits to Cameco in Canada.

The Court additionally analyzed the OECD *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* dated July 1995 ("1995 guidelines"). The 1995 guidelines provided two situations when a tax administration could disregard a structure put in place by a taxpayer. However, the Court did not find Cameco falling into these circumstances. Therefore, the Court must respect Cameco's multinational corporate structure.

Conclusions on Paragraphs 247(2)(b) and (d)

The FCA concluded that the Minister could not simply reallocate all the foreign subsidiary's profits to the Canadian parent as if those subsidiaries did not exist. Doing such was an improper use of 247(2)(b) and (d). What the Minister did was use hindsight to suggest that this transaction would not have occurred if it were with arm's length parties; however, the parties had no idea that the price of uranium would increase substantially from the time CEL/CESA purchased and sold it.

Alternative Argument on Paragraph 247(2)(a) Interpretation

The Crown alternatively argued that the TCC improperly interpreted paragraph 247(2)(a), which could also allow for an adjustment under 247(2)(d):

(a) the terms or conditions made or imposed, in respect of the transaction or series, between any of the participants in the transaction or series differ from those that would have been made between persons dealing at arm's length.

Specifically, the Crown submitted that the Tax Court judge should have favoured the evidence by its experts rather than Cameco's. However, the FCA found no basis for its Court to intervene with the weighing of evidence absent palpable and overriding error.

Implications

There are several key takeaways from both the FCA decision and the SCC's decision to deny leave. First, the FCA allowed Cameco's transaction, which provides the company with a significantly lower tax obligation than if the FCA had decided against Cameco. This means a loss in revenue for Canada. The Tax Court Judge also awarded Cameco costs of $10,250,000, which the FCA or SCC never denied.

With respect to the Act's transfer pricing regime, *Cameco* clarified the interpretation of 247(2)(b). Specifically, the paragraph refers to a hypothetical person from an objective perspective rather than the particular taxpayer in the situation.

Lastly, there are times when it may be appropriate for section 247 to pierce the corporate veil and ignore an enterprise's corporate structure. However, this particular transaction is not one of them. *Cameco* has therefore highlighted another instance of when the transfer pricing regime is limited in its piercing capabilities.

GSK Canada [2010 FCA 201]

The case was returned to the Tax Court of Canada for consideration of the License Agreement as a circumstance relevant to the determination of the transfer pricing used by the taxpayer.

In short, the Court states that the “contractual terms” as a whole is a key factor to determine the arm’s length price of a controlled transaction. This is factor number 3 of the comparability analysis as per the OECD Transfer Pricing Guidelines.

In 1976, a predecessor of GlaxoSmithKline ("GSK") discovered the drug ranitidine, which was approved for sale in Canada in 1981 and marketed as Zantac. Ranitidine's primary manufacture was conducted by related companies located in the United Kingdom and Singapore, and it was subsequently sold to Adechsa SA, another related company located in Switzerland, for further sale to other group companies and unrelated distributors at prices dictated by the parent company.

In addition, the following intercompany agreements were entered into by Glaxo Canada:

- In 1972, a Consultancy Agreement with Glaxo Group Limited covering services and intangibles provided to Glaxo Canada in exchange for a 5% royalty;
- In 1983, a Supply Agreement with Adechsa for the purchase of ranitidine;
- An amendment to the 1972 agreement, to cover services and intangibles relating to Zantac; and
- In 1988, a Licence Agreement with Glaxo Group Limited that replaced the 1972 agreement, and which covered various services and intangibles, in exchange for a 6% royalty on the net sales of drugs.

During its taxation years from 1990 to 1993, Glaxo deducted and remitted withholding tax with respect to royalty payments it made to Glaxo Group Limited under the 1988 agreement, but not with respect to payments to Adechsa under the 1983 agreement, which were considered fully deductible as cost of goods sold.

By 1990, generic drug manufacturers such as Apotex and Novopharm were able to acquire ranitidine on the open market at prices significantly less than Glaxo Canada was paying under its 1983 agreement. The Minister of National Revenue subsequently reassessed Glaxo Canada's 1990–1993 taxation years under:

- s. 69(2),which applied where a taxpayer is not dealing at arm's length with a non-resident and pays an amount greater than the amount "that would have been reasonable in the circumstances if the non-resident person and the taxpayer had been dealing at arm's length". In such a case, the transfer price is deemed to be the reasonable amount determined on an arm's length basis.

- s. 56(2), which resulted in a deemed dividend to Adechsa, and its assessment for withholding tax under Part XIII of the *ITA*.

Glaxo Canada subsequently appealed the reassessments to the Tax Court of Canada.

Tax Court of Canada

On 30 May 2008, the TCC allowed the appeals, ordering the s. 69(2) and Part XIII assessments to be returned to the Minister for reassessment with respect to a minor pricing adjustment. Otherwise, the approach used in arriving at the assessments was considered to be correct. Rip A.C.J. (as he then was) identified the key issues in the case as:

- Whether the Supply Agreement and the Licence Agreement should be considered together to determine a reasonable transfer price;

- The meaning of the phrase "reasonable in the circumstances" in s. 69(2); and

- The impact of the differences in Glaxo's good manufacturing practices and health, safety and environmental standards on the comparability of the ranitidine purchased by the appellant with that purchased by the generic companies.

He ruled that the comparable uncontrolled price method was the preferred approach to use to establish the arm's length transfer price, subject to adjustment for the issues in dispute. He also ruled that the Part XIII assessments for withholding tax were essentially correct, but subject to a minor pricing adjustment with respect to the drug's granulation.

Federal Court of Appeal

The TCC ruling was set aside by the Federal Court of Appeal on 26 July 2010. In his ruling Nadon J.A. stated that the trial judge had erred in concluding that the Licence Agreement and Supply Agreement were to be considered independently of one another within the context of *Singleton v. Canada* misunderstanding the s. 69(2) test of what is "reasonable in the circumstances".

The *Singleton* test applied to a different part of the Act under different circumstances, and the consideration of what is reasonable must be governed by the standard noted in *Gabco Limited v. Minister of National Revenue*, where Cattanach J. stated:

"It is not a question of the Minister or this Court substituting its judgment for what is a reasonable amount to pay, but rather a case of the Minister or the Court coming to the conclusion that no reasonable business man would have contracted to pay such an amount having only the business considerations of the appellant in mind."

Transfer Pricing with a Competitive External Market

Nadon J.A. subsequently listed the following "circumstances" of what could be considered as reasonable in the case at bar:

1. Glaxo Group owned the Zantac trademark and would own it even if the appellant was an arm's length licensee.

2. Zantac commanded a premium over generic ranitidine drugs.

3. Glaxo Group owned the ranitidine patent and would have owned it even if the appellant had been in an arm's length relationship.

4. Without the License Agreement, the appellant would not have been in a position to use the ranitidine patent and the Zantac trademark.

Consequently, in those circumstances, the only possibility open to the appellant would have been to enter the generic market where the cost of entry into that market would likely have been high, considering that both Apotex and Novopharm were already well placed and positioned. Without the License Agreement, the appellant would not have had access to the portfolio of other patented and trademarked products to which it had access under the License Agreement. The appeal was allowed with costs, setting aside the Tax Court's decision, and the matter was returned to the trial judge for rehearing and reconsideration of the matter in the light of the FCA's reasons.

An appeal by the Crown on the reversal, and cross-appeal by GSK with respect to the case being returned to the TCC for rehearing, were subsequently made to the Supreme Court of Canada, which heard the case on 13 January 2012.

Appeal

The Crown argued that applying a "reasonable in the circumstances" test, as the FCA did, does not fulfil the conditions of section 69(2), as a price that may be reasonable is not necessarily an arm's-length price. According to the Crown, only those circumstances that would be relevant to parties bargaining at arm‟s length for a particular good should be considered in the analysis, which it asserted was supported by the SCC's rulings in *Singleton* and *Shell Canada Ltd. v. Canada*. In its view, other circumstances, such as Glaxo Canada‟s status as a distributor of Zantac, were irrelevant to the consideration of the price paid for ranitidine.

In response to questions from the Justices about the meaning of "reasonable circumstances" in s. 69(2), the Crown submitted that:

- the phrase was intended to consider only the "economically relevant circumstances" pertaining to the specific transaction in question, in accordance with the *OECD Transfer Pricing Guidelines*; and
- s. 69(2) did not allow consideration of "the whole deal".

As to questions as to whether a hypothetical independent licensee entering into a similar arrangement with Glaxo could be reassessed in the same manner, the Crown responded that such a licensee could be reassessed as not "dealing at arm's length" if it was tied into a set price and had no ability to bargain.

In its submission, GSK concurred with the FCA ruling with respect to the inclusion of the License Agreement in determining reasonable circumstances. S. 69(2) should therefore be presumed to situate the parties at arm's length, ultimately asking, "Would they do the deal?" As to questions posed on whether the price paid for ranitidine was a bundled price for tangible and intangible property—thus potentially triggering liability for withholding tax—GSK contended that the situation was analogous to luxury brands such as Rolex and Porsche. While there are undoubtedly components of intellectual property embedded in the price of the tangible good, it is not Canadian law or practice to segregate and separately tax the discrete elements.

As to the applicability of the OECD guidelines, GSK stated that there was no dispute between the parties that the issue in question is solely the price of the tangible good rather than its characterization.

<u>Cross-appeal</u>

In its cross-appeal, GSK submitted that it had demolished the Minister's reassessment by demonstrating that the theory at the heart of the liability determined by the Minister was wrong, and therefore the reassessment must be set aside. To a question posed as to whether the onus was still on the taxpayer to prove that it did not overpay for ranitidine (as the lower courts had not yet addressed the issue), GSK responded that, once it had demolished the Crown's basis for reassessment, the onus shifted to the Crown to show that Glaxo had paid too much.

In reply, the Crown contended that GSK did not demolish the reassessment, and therefore it remained valid and open for reconsideration by the TCC. To the question of whether, if the case were to be sent back to the TCC, any other issue could be argued, the Crown stated that the argument would remain essentially the same, as the generic comparable prices comprised the only available information to support arm's-length prices for ranitidine.

<u>Decision by the SCC</u>

<u>Appeal</u>

While s. 69(2) does not state what is a "reasonable amount", the OECD guidelines do provide commentary and methodology pertaining to the issue of transfer pricing. However, the test of any set of transactions or prices ultimately must be determined according to s. 69(2).

- The trial judge erred in relying on *Singleton* and *Shell Canada* for requiring a transaction-by-transaction approach, but s. 69(2) only requires that the price established in a non-arm's length transfer pricing transaction is to be redetermined as if it were between parties dealing at arm's length. If the circumstances require, transactions other than the purchasing transactions must be taken into account to determine whether the actual price was or was not greater than the amount that would have been reasonable had the parties been dealing at arm's length.

- The OECD Guidelines state that a proper application of the arm's length principle requires that regard be had for the "economically relevant characteristics" of the arm's length and non-arm's length circumstances to ensure they are "sufficiently comparable".

- Considering the Licence and Supply agreements together offers a realistic picture of the profits of Glaxo Canada. It cannot be irrelevant that Glaxo Canada's function was primarily as a secondary manufacturer and marketer. It did not originate new products and the intellectual property rights associated with them. Nor did it undertake the investment and risk involved with originating new products. Nor did it have the other risks and investment costs which Glaxo Group undertook under the Licence Agreement. The prices paid by Glaxo Canada to Adechsa were a payment for a bundle of at least some rights and benefits under the Licence Agreement and product under the Supply Agreement.

It was also noted that the issue as to whether the purchase price includes compensation for intellectual property rights granted to Glaxo Canada had not been specifically argued before the SCC, and could still trigger potential further liability for Part XIII withholding tax. It may still be raised during the subsequent rehearing at the TCC.

The following further guidance was given with respect to the forthcoming redetermination by the trial judge:

- In determining what constitutes a "reasonable amount" under s. 69(2), even the OECD guidelines concede that "transfer pricing is not an exact science". As long as a transfer price is within what the court determines is a reasonable range, the requirements of the section should be satisfied.

- While assessment of the evidence is a matter for the trial judge, the respective roles and functions of Glaxo Canada and the Glaxo Group should be kept in mind. Whether or not compensation for intellectual property rights is justified in this particular case, is a matter for determination by the Tax Court judge.

- Prices between parties dealing at arm's length will be established having regard to the independent interests of each party to the transaction, and an appropriate determination under the arm's length test of s. 69(2) should reflect these realities.

- In this case there is some evidence that indicates that arm's length distributors have found it in their interest to acquire ranitidine from a Glaxo Group supplier, rather than from generic sources. This suggests that higher-than-generic transfer prices are justified and are not necessarily greater than a reasonable amount under s. 69(2).

<u>Cross Appeal</u>

The assessments were based on two assumptions:

1. The Appellant paid Adechsa, with whom it was not dealing at arm's length, a price for ranitidine which was greater than the amount that would have been reasonable in the circumstances if the Appellant and Adechsa had been dealing at arm's length.

2. Any amounts paid by the appellant to Adechsa over and above the prices paid by other Canadian pharmaceutical companies were not for the supply of ranitidine.

Only the second could be characterized as having been demolished, but if Glaxo had been successful in establishing that the prices it paid were reasonable, the first would have been demolished as well. As L'Heureux-Dubé J. had stated in *Hickman Motors Ltd. v. Canada*, the taxpayer's burden is to "'demolish' the exact assumptions made by the Minister but no more".

As Glaxo had previously conceded at the FCA that the court could determine what was the reasonable amount, it was within the FCA's discretion to remit the question to the TCC for that very determination. Accordingly, that aspect of the FCA's ruling was upheld.

Impact

There has been little jurisprudence on transfer pricing in Canada, and, being the first time this area had been addressed by the SCC, the judgment was greatly anticipated, not just in Canada but worldwide. While many tax professionals welcomed the SCC endorsement of a "business reality test", others had been expecting more specific guidance. There was also speculation that the time may be ripe for the Crown and GSK to reach a settlement, rather than spend more time in pursuing a rehearing at the TCC. The case was ultimately settled on 12 January 2015, prior to the TCC's rehearing of the matter, with details of the agreement remaining confidential.

The SCC's statement that an arm's-length price can fall within an acceptable range of prices has also been seen as significant, and consistent with the 2010 OECD transfer pricing guidelines, as it appears to be contrary to the long-standing policy of the Canada Revenue Agency to express a preference for unweighted yearly averages of comparators' pricing in such circumstances. In addition, the SCC's guidance to the TCC strongly suggests that Canadian courts must keep an eye on the bigger picture in making their transfer pricing determinations, and the determination of arm's-length pricing is quite distinct from the narrower concept of fair market value.

When s. 69(2) was re-enacted as s. 247(2)(a) and (c) in 1998, the test as to what was reasonable "in the circumstances" was removed. However, it has been contended that the quoted words are implicit in the comparative exercise mandated by the explicit adoption of the arm's-length principle in subsection 247(2) and the Tax Court of Canada has held that *GlaxoSmithKline's* reasoning continues to apply to s. 247 cases. It should be noted that s. 247 also contains a recharacterization rule at s. 247(2)(b) and (d) that has yet to be assessed in the Canadian courts.

Most recently, it has been argued that the SCC erred in affirming the FCA's application of a reasonable business person test for the purpose of s.69(2), and that the SCC infused additional uncertainty as to which arm's length test applies (i.e., an empirical arm's length test or a reasonable business person test). These errors may require having the court overrule its decision in order to properly consider the Minister's question about the appropriateness of the reasonable business person test.

SNF (Australia) Pty Ltd [Full Federal Court Decision, 2011 FCAFC 74]

The case concerned the deductibility of purchases by SNF Australia which was a wholly owned subsidiary of SPMC SA, formerly SNF SA (SNF France) a company resident in France. SNF Australia carried on the business of manufacturing and selling products (commonly called "flocculants and coagulants") to end users in the mining, paper and sewage treatment industries in Australia. During the years 1998 to 2004, SNF Australia purchased its supplies, at a price of some $71 million, from other subsidiaries that were resident in France, the USA and China. SNF Australia sustained trading losses in most income years between 1991 and 2004, except in 1995 and 1997, when small accounting profits were made.

Following an Australian Taxation Office (ATO) transfer pricing audit of SNF Australia, the Commissioner in March 2007 made determinations pursuant to the Australian transfer pricing provisions with respect to the prices paid for the acquisitions from these subsidiaries and issued notices of assessment with respect to the 1998 to 2000 and 2002 to 2004 income years.

The Full Federal Court (Court) unanimously held that SNF Australia had proved that the prices paid by it were less than the prices paid by independent comparable purchasers. Thus the Court said those prices were arm's length and SNF Australia's prices did not therefore exceed arm's length consideration. Further, the Court made several comments in relation to the interpretation of Australia's domestic law and international agreements which are discussed below.

In applying our domestic transfer pricing provisions, particularly the requirements of section 136AD(3) of the ITAA36, the Court firmly rejected the Commissioner's approach in that applying the arm's length principle, SNF Australia must look at purchases in identical circumstances – refer paragraphs 101 and 102.

Further, in accepting that SNF Australia had raised appropriate comparable transactions involving the acquisition of the same or sufficiently similar products in the same or similar circumstances, the Court rejected a narrower approach to the application of section 136AD(3) which the Commissioner of Taxation (Commissioner) argued was supported, amongst other things, by the OECD's *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD TP Guidelines). This narrower approach may have allowed the Commissioner to apply a profit based method (in this case, the transactional net margin method (TNMM)) or more particularly make a determination of arm's length consideration based on the Commissioner's arguably very broad powers of section 136AD(4) of the ITAA36.

Section 136AD(4) provides a power which the Commissioner has threatened in various transfer pricing audits / reviews. It could potentially allow the Commissioner, where it is not possible or practical to ascertain the arm's length consideration with respect to an international transaction (including because of an insufficiency of information available), to deem an arm's length consideration to be applicable as per the Commissioner's determination. The Court rejected the need to apply section 136AD(4) in these circumstances and generally accepted that there may be more than one arm's length price. However, it was held that the taxpayer had demonstrated that the prices paid were arm's length or less than arm's length prices and thus it had absolved itself of the burden of proof and effectively rendered the Commissioner powerless in pursuing adjustments under sections 136AD(3) or (4).

In June 2010, the Federal Court (Middleton J) in *SNF (Australia) Pty Ltd v FCT* [2010] FCA 635 held that transfer pricing determinations made by the ATO could not stand and that SNF Australia had satisfied the burden of proving that the amounts it had paid for products from the suppliers had been acquired at arm's length consideration.

After evaluating expert evidence given by both parties, the Federal Court concluded that on the basis of the comparable sales methodology, the actual prices paid by SNF Australia for the acquisition of the products were in fact lower than the large majority of prices paid by purchasers in comparable transactions on a global basis over a similar period.

In relation to the fact that SNF Australia had incurred sustained trading losses over the years in question, the Federal Court said that this was irrelevant to applying the test of whether arm's length consideration had been paid in respect of the acquisitions.

Details of the Full Federal Court Decision

The Court considered a number of significant issues which are discussed in detail below.

Comparable Transactions

SNF Australia prepared three sets of comparable transactions to support its position that it had paid arm's length consideration. The first set, prepared by the SNF Group, consisted of five specified foreign companies; the second set, a group of Australian and New Zealand companies; the third set, prepared by an external adviser, was a larger group of 21 companies.

The Commissioner contended that all the sets of comparables were not appropriate to determine an arm's length price for Australian transfer pricing purposes. However, the Court rejected the Commissioner's submissions and held that the first set and a modified version of the third set of comparables were appropriate in determining an arm's length price, with the key reasons being as follows.

For the first set of comparables, the Court was satisfied that SNF Australia and the five chosen companies were all distributors (as opposed to end-users) of the products acquired from the SNF Group:

- The Court also accepted the comparability analysis undertaken SNF Australia's expert witness, which was based on the five comparability factors set out in the OECD's TP Guidelines which supported the comparables used in the first set. The OECD's comparability factors were: the characteristics of the property in question; the functions of the proposed comparables; the contractual terms and conditions on which the comparable transactions took place; the economic circumstances of the markets in which the transactions occurred; and the business strategies of the respective parties;

- A key factor accepted by the Court was the existence of a global market for the products purchased by SNF Australia. Importantly, the existence of that global market meant there was nothing preventing the taxpayer from using companies and transactions from different countries as comparables for transfer pricing purposes;

- The Court held that the second set of comparables was not appropriate to determine an arm's length price since SNF Australia did not establish that the companies were in the same business as SNF Australia (in particular, as distributors);

- For the third set of comparables, which was based on the individual products sold by SNF France, the Court held that approximately half of the compared companies were not comparable because their status as distributors had not been established. Nonetheless, the Court was satisfied that the remaining companies were comparable and the price analysis for these companies demonstrated that SNF Australia generally paid lower prices than the comparables.

On this basis, the Court was satisfied that there were appropriate comparables available to determine an arm's length price for the products purchased by SNF Australia. Accordingly, the Court rejected the Commissioner's submission that a different transfer pricing methodology, in particular the TNMM, was required to be applied in these circumstances.
The Commissioner relied on the OECD TP Guidelines as support in respect of its submissions relating to arm's length consideration. The Court held that the Guidelines were not a legitimate aid to the construction of the DTAs for the following reasons at paragraphs 116 to 118:

"116. ...In order to permit recourse to the guidelines it would therefore be necessary to show that Australia and each of China, the US and France had either agreed to apply to portion of the guidelines relied upon in their performance of the equivalent of Article 9 of each agreement or that it was their practice to do so.

117. There was no evidence that any of the States in question had adopted the practice of applying the guidelines to any of the circumstances in which Article 9 of the Model Law might obtain in their jurisdictions. It must therefore follow that they may not be examined. This conclusion, it should be emphasised, should not foreclose any future attempt to demonstrate that the guidelines do, in fact, evidence State practice.

118. The guidelines are not a legitimate aid to the construction of the double taxation treaties."
Further, the Court rejected the Commissioner's submissions that the OECD TP Guidelines could be used to assist in the interpretation of the domestic transfer pricing provisions (i.e. Division 13). In this regard, the Court held at paragraphs 118 and 119:

"118... The fact that the provisions are the domestic embodiment of Article 9 of the Model Law does not alter their nature as Australian law and it in that capacity that this Court is required to interpret them. There is no principle of statutory interpretation which requires domestic legislation of the present kind to be read as if it were itself an international agreement...

119. Where, however, the domestic provisions are obscure or unclear then it would be unsound not to attempt to resolve that ambiguity in a way which is consistent with Australia's obligations."

However, the Court noted that it was appropriate to interpret domestic law (i.e. Division 13 of the ITAA36) in accordance with the ordinary principles governing the interpretation of DTAs where Parliament incorporated the whole text of a DTA in domestic law. The use of the DTA by the Parliament indicated its intention to fulfil its international obligations. However, the Court stated that the domestic transfer pricing provisions did not adopt and apply the whole text of the DTA.

The Court does not expressly discuss the use of the Model Law, its commentary and its role in interpreting DTAs and domestic law. However, the Court notes that the interpretation adopted in respect of the domestic transfer pricing provisions is consistent with the Model Law and its commentary.

Taxpayer's losses - although not raised as an issue on appeal, the Court agreed with Middleton J the fact that SNF Australia had incurred sustained trading losses over the years in question was irrelevant in determining the arm's length consideration for transfer pricing purposes.

The key implications from this case may be summarised as follows:

- The Full Federal Court's decision provides a clear and cogent analysis of the relevant tax issues, in particular, the interpretation of Australia's domestic transfer pricing provisions and the relevance / application of international tax agreements, commentary and other guidelines on their interpretation.

- As a starting point, domestic provisions should not be interpreted as if it were an international agreement. However, where the domestic provisions are obscure or unclear then the ambiguity may be resolved in a manner which is consistent with Australia's international obligations.

- It is appropriate to interpret domestic provisions in accordance with the ordinary principles governing the interpretation of DTAs where the Australian Parliament incorporated the whole text of a DTA in domestic law.

- The OECD TP Guidelines are not a legitimate aid to the interpretation of DTAs or Australia's domestic transfer pricing provisions.

- So long as appropriate comparable transactions are available, an analysis of relevant comparables (e.g. the 'comparable uncontrolled pricing' method) is an appropriate method to determine an arm's length price for transfer pricing purposes.

- If there is a global market for the relevant product or service, taxpayers may use comparables from countries and regions other than Australia in determining an arm's length price.

- When identifying appropriate comparables to determine an arm's length price for transfer pricing purposes, the selected entity comparables should carry out similar activities to the taxpayer (i.e. have 'functional comparability' with the taxpayer).

Question 8

Part 1

The OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting (BEPS) has brought together over 125 countries and jurisdictions to collaborate on the implementation of the BEPS Package.

BEPS refers to tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity. Although some of the schemes used are illegal, most are not. This undermines the fairness and integrity of tax systems because businesses that operate across borders can use BEPS to gain a competitive advantage over enterprises that operate at a domestic level. Moreover, when taxpayers see multinational corporations legally avoiding income tax, it undermines voluntary compliance by all taxpayers.

BEPS is of major significance for developing countries due to their heavy reliance on corporate income tax, particularly from multinational enterprises. Engaging developing countries in the international tax agenda is important to ensure that they receive support to address their specific needs.

The BEPS package provides 15 Actions that equip governments with the domestic and international instruments needed to tackle BEPS. Countries now have the tools to ensure that profits are taxed where economic activities generating the profits are performed and where value is created. These tools also give businesses greater certainty by reducing disputes over the application of international tax rules and standardising compliance requirements.

OECD and G20 countries along with developing countries that participated in the development of the BEPS Package are establishing a modern international tax framework under which profits are taxed where economic activity and value creation occur. Work will continue to be carried out to support all countries interested in implementing and applying the rules in a consistent and coherent manner, particularly those for which capacity building is an important issue.

The OECD members and G20 countries have developed an Inclusive Framework (IF) on BEPS which allows interested countries and jurisdictions to work with OECD and G20 members on developing standards on BEPS related issues and reviewing and monitoring the implementation of the whole BEPS Package.

Monitoring implementation and the impact of the different BEPS measures is a key element of the work ahead. Members of the IF will develop a monitoring process for the four minimum standards as well as put in place the review mechanisms for other elements of the BEPS Package. The monitoring of the four minimum standards will ensure that all members, as well as jurisdictions of relevance, will comply with the standards in order to ensure a level playing field. Monitoring mechanisms are going to be developed in order to monitor jurisdictions' compliance with their commitments. These mechanisms will ensure the effectiveness of the filing and dissemination of the Country-by-Country reports, as provided for by the review of the Country-by-Country standard by 2020. In regards to review mechanisms, they may differ depending on the Actions and will take into account countries' specific circumstances. All countries and jurisdictions joining the framework will participate in this review process, which allows members to review their own tax systems and to identify and remove elements raising BEPS risks.

Peer review and monitoring process of the four minimum standards:

- Action 5 – preferential regimes and AEOI;
- Action 6 – Treaty abuse to be addressed by a Principle Purpose Test or LOB test;
- Action 13 – Documentation including Country-by-Country reporting; and

- Action 14 – Improved Mutual Agreement Procedures for resolving disputes.

The Inclusive Framework will also support the development of the toolkits for low-capacity developing countries. The G20 Development Working Group has requested the IMF, the OECD, the UN and the WBG to work together on the development of toolkits and guidance to support low-capacity developing countries to address BEPS issues. The toolkits are being prepared to help developing countries implementing measures to tackle BEPS as well as other issues that developing countries have identified as priorities during the regional consultations. The inclusive framework will allow members to feed their views into the toolkit work, and likewise the latter might impact the remaining BEPS standard-setting work.

The interaction between international organisations, although independent, will be connected with the inclusive framework. The involvement of the international organisations as Observers in the inclusive framework will facilitate their collaboration. It will offer participants the opportunity to receive coordinated and targeted capacity building support in the implementation of the BEPS outcomes.

The more comprehensive responses will know that OECD/G20 IF mandate for future work includes supporting other jurisdictions to implement the BEPS package, through guidance on the standards, or direct bilateral support and regional capacity building. The ongoing technical work on BEPS challenges covers developing guidance on outstanding transfer pricing issues, and setting standards for BEPS challenges around the digitalised economy, assistance by gathering data to monitor the other aspects of implementation, including under BEPS Actions 1 (on the tax challenges of the digitalised economy) and 11 (on measuring and monitoring BEPS).

The OECD's Action Plan on BEPS was published in July 2013 with a view to addressing perceived flaws in international tax rules. The 40-page Action Plan, which was negotiated and drafted with the active participation of its member states, contained 15 separate action points or work streams, some of which were further split into specific actions or outputs. The Plan was squarely focused on addressing these issues in a coordinated, comprehensive manner, and was endorsed by G20 leaders and finance ministers in September 2013.

The recommendations of the BEPS Project were published in October 2015. At the completion of this scheduled programme, it started to be recognised as the end of phase one of the project and the start of phase two, dealing with outstanding or additional work, implementation and monitoring.

Fundamental changes are needed to effectively prevent double non-taxation, as well as cases of no or low taxation associated with practices that artificially segregate taxable income from the activities that generate it.

New international standards must be designed to ensure the coherence of corporate income taxation at the international level.

A realignment of taxation and relevant substance is needed to restore the intended effects and benefits of international standards, which may not have kept pace with changing business models and technological developments.

The actions implemented to counter BEPS cannot succeed without further transparency, nor without certainty and predictability for business.

Addressing the tax challenges of the digital economy

Action 1 addresses the tax challenges of the digital economy and identifies the main difficulties that the digital economy poses for the application of existing international tax rules. The Report outlines options to address these difficulties, taking a holistic approach and considering both direct and indirect taxation.

Neutralising the effects of hybrid mismatch arrangements

Action 2 develops model treaty provisions and recommendations regarding the design of domestic rules to neutralise the effects of hybrid instruments and entities (e.g. double non-taxation, double deduction, long-term deferral).

Designing effective controlled foreign company (CFC) rules

Action 3 sets out recommendations to strengthen the rules for the taxation of controlled foreign corporations (CFC).

Limiting base erosion involving interest deductions and other financial payments

Action 4 outlines a common approach based on best practices for preventing base erosion through the use of interest expense, for example through the use of related-party and third-party debt to achieve excessive interest deductions or to finance the production of exempt or deferred income.

Countering harmful tax practices more effectively, taking into account transparency and substance

Action 5 revamps the work on harmful tax practices with a focus on improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes, and on requiring substantial activity for preferential regimes, such as IP regimes.

Preventing the granting of treaty benefits in inappropriate circumstances

Action 6 develops model treaty provisions and recommendations regarding the design of domestic rules to prevent treaty abuse.

Preventing the artificial avoidance of permanent establishment status

Action 7 contains changes to the definition of permanent establishment to prevent its artificial circumvention, e.g. via the use of commissionaire structures and the likes.

Aligning transfer pricing outcomes with value creation

Actions 8-10 contain transfer pricing guidance to assure that transfer pricing outcomes are in line with value creation in relation to intangibles, including hard-to-value ones, to risks and capital, and to other high-risk transactions.

Measuring and monitoring BEPS

Action 11 establishes methodologies to collect and analyse data on BEPS and the actions to address it, develops recommendations regarding indicators of the scale and economic impact of BEPS and ensure that tools are available to monitor and evaluates the effectiveness and economic impact of the actions taken to address BEPS on an ongoing basis.

Mandatory disclosure rules

Action 12 contains recommendations regarding the design of mandatory disclosure rules for aggressive tax planning schemes, taking into consideration the administrative costs for tax administrations and business and drawing on experiences of the increasing number of countries that have such rules.

Transfer pricing documentation and country-by-country reporting

Action 13 contains revised guidance on transfer pricing documentation, including the template for country-by-country reporting, to enhance transparency while taking into consideration compliance costs.

Making dispute resolution mechanisms more effective

Action 14 develops solutions to address obstacles that prevent countries from solving treaty-related disputes under MAP, via a minimum standard in this area as well as a number of best practices. It also includes arbitration as an option for willing countries.

Developing a multilateral instrument to modify bilateral tax treaties

Action 15 provides an analysis of the legal issues related to the development of a multilateral instrument to enable countries to streamline the implementation of the BEPS treaty measures, as well as the mandate to carry out that work in 2016.

Part 2

The tax challenges of the digitalisation of the economy were identified as one of the main areas of focus of the BEPS Action Plan, leading to the 2015 BEPS Action 1 Report. For direct taxes, the Action 1 Report observed that while digitalisation could exacerbate BEPS issues, it also raises a series of broader tax challenges, which it identified as "nexus, data and characterisation". The latter challenges, however, were acknowledged as going beyond BEPS, and were described as chiefly relating to the question of how taxing rights on income generated from cross-border activities in the digital age should be allocated among jurisdictions. Possible options to address these concerns were identified, but none were agreed or ultimately recommended as part of the BEPS package. Instead, the Action 1 Report called for continued work in this area with a further report to be delivered by 2020.

In March 2017, this timeline was accelerated, with the OECD/G20 Inclusive Framework on BEPS (Inclusive Framework) working through its Task Force on the Digital Economy (TFDE), for an Interim Report, which was delivered in March 2018 (the Interim Report). It contained an in-depth analysis of new and changing business models and possible implications for the international tax system (in particular nexus and profit allocation rules). The Interim Report also repeated the conclusion from the Action 1 report that it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy. While members of the Inclusive Framework did not agree on the conclusions to be drawn from this analysis, they committed to continue working together on the development of a consensus-based long-term solution by 2020, with an update in 2019.

The OECD/G20 IF on BEHSP has been working on a developing a two-pillar approach since 2019.

The Inclusive Framework and jurisdictions on an equal footing for multilateral negotiation of international tax rules, decided during its 29-30 January 2020 meeting to move ahead with a two-pillar negotiation to address the tax challenges of digitalisation.

In light of the strong support from the Inclusive Framework members for reaching a multilateral agreement with respect to Pillar One and Pillar Two, and drawing on the technical work of the Working Parties, comments from the public consultation, as well as the discussion at a number of Steering Group meetings, and recognising the concurrent work on a without prejudice basis on the two pillars, members of the Inclusive Framework affirm their commitment to reach an agreement on a consensus-based solution by the end of 2020. In further developing the two Pillars, the Inclusive Framework has therefore agreed upon an outline of the architecture of a Unified Approach on Pillar One as the basis for negotiations and welcomed the progress made on Pillar Two (which follows the outline of Pillar Two in the PoW) contained in Annexes 1 and 2 of this statement.

In 2020, the international community has made substantial progress towards reaching a consensus-based long-term solution to the tax challenges arising from the digitalisation of the economy, and agreed to keep working towards an agreement by mid-2021.

This culminated in the OECD/G20 Inclusive Framework publishing blueprints in October 2020 of the two-pillar approach on key policy features, principles and parameters for a future agreement. They identified remaining political and technical issues where differences of views remain to be bridged, and next steps in the multilateral process.

The Blueprint for Pillar One proposes to establish new rules on where tax should be paid (“nexus” rules) and a fundamentally new way of sharing taxing rights between countries. The aim is ensure that digitally-intensive or consumer-facing MNEs pay taxes where they conduct sustained and significant business, even when they do not have a physical presence, as is currently required under existing tax rules.

The Blueprint for Pillar Two proposes to introduce a global minimum tax that would help countries around the world address remaining issues linked to base erosion and profit shifting by MNEs.

The absence of a consensus-based solution, on the other hand, could lead to a proliferation of unilateral digital services taxes and an increase in damaging tax and trade disputes, which would undermine tax certainty and investment, the OECD said. Under a worst-case scenario – a global trade war triggered by unilateral digital services taxes worldwide - the failure to reach agreement could reduce global GDP by more than 1% annually.

The Inclusive Framework and TFDE have re-engaged in 2021 and are seeking to reach international consensus regarding Pillar One and Pillar Two by July 2021.

Question 9

Part 1

Country by Country (CbC) data was a key priority in addressing BEPS risks, per OECD Action 13 Report which recommended that reporting take place from periods commencing after 1 January 2016. CBC Guidelines contains rules for consistency in documentation standards of reporting.

The requirement to file a CbC report applies to the ultimate parent entity (UPE) of a group, where the annual consolidated group revenue is equal to or higher than EUR 750 million.

The UPE is required to file a CbC Report on behalf of the group with its local tax authority within 12 months or a period prescribed, of its fiscal year reporting.

Such reports are then exchanged with other jurisdictions under bilateral treaties, multilateral treaties (incl. Multilateral Convention) or TIEAS or Automatic Exchange of Information.

From a tax administrations perspective, CBC is likely to have the following benefits:

- Standard documentation automatically provided by an MNE group will it easier to identify potential transfer pricing risks.
- Enable access to better quality documentation in a more timely manner and without requiring a review, audit, examination or related activity to be undertaken.
- May encourage multinationals to be more transparent with factual information regarding business operations, profitability in countries and value chain.
- May lead to more APA's and MAP's with better quality information.
- Ability to carry out transfer pricing risk assessment without for the need to request additional documentation.

Part 2

Candidates who provide more comprehensive responses will address the definition and provide a general explanation of an advance pricing arrangement (APA), including the benefits.

An APA is defined in the OECD Guidelines as "an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (e.g. method, comparables and appropriate adjustments, critical assumptions) 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 APA's. There are benefits and disadvantages (F.3 of OECD Guidelines) of entering into an APA and the different types of APA's.

The types of APAs (Part F of Chapter IV of TPG) 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).

Whether an MNE enters into an APA and the type of APA will depend on a number of practical considerations, for example:

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

Key benefits include:

- Certainty in relation to future years of lodgement for transfer pricing outcomes.
- Risk mitigation - Reduced chance of future compliance activity by tax administrations.
- Reduce likelihood of double taxation (predominantly Bilateral APA).
- More efficient use of resources with less requirement to prepare detailed transfer pricing documentation for future years (though still required to prepare CbC documents).
- Potential to rollback APA outcome to earlier years.
- Fostering positive relationship with tax administration.

<u>Part 3</u>

A Cost Contribution Arrangement (CCA) is a contractual agreement reached between enterprises under which those members share the contributions/costs and risks of producing or purchasing certain assets (tangible or intangible), services or rights and an agreed process for sharing the results that arise from the utilisation of those assets, services or rights.

CCAs can often be used for the joint development, enhancement, maintenance, protection or exploitation of intangibles. A key objective in revising the OECD guidance is to align the transfer pricing of intangibles under CCA's to be measured at value rather than at cost. This aligns that outcomes for parties under a CCA should not differ significantly from the outcomes of transfers or development of intangibles for parties outside a CCA.

In accordance with the arm's length principle, each participant's proportionate share of the overall contributions to a CCA must be consistent with the participant's proportionate share of the overall expected benefits to be received under the arrangement. Further, each participant becomes an effective owner of an interest in any intangibles or tangible assets resulting from the activity of the CCA, or is entitled to receive services resulting from the activity of the CCA, and may exploit such interest or entitlement without paying additional consideration to any party for that interest or entitlement.

Some benefits of the CCA activity can be determined in advance, whereas others will be uncertain. Some types of CCA activities will produce current benefits, while others have a longer time frame or may not be successful. Nevertheless, in a CCA there is always an expected benefit that each participant seeks from its contribution, including the attendant rights to have the CCA properly administered. Each participant's interest in the results of the CCA activity should be established from the outset, even where the interest is inter-linked with that of other participants, e.g. because legal ownership of developed intangibles or tangible assets may be vested in only one of them but all of them have effective ownership interests.

For the conditions of a CCA to satisfy the arm's length principle, the value of participants' contributions must be consistent with what independent enterprises would have agreed to contribute under comparable circumstances given their proportionate share of the total anticipated benefits they reasonably expect to derive from the arrangement.

The expectation of mutual and proportionate benefit is fundamental to the acceptance by independent enterprises of an arrangement for pooling resources and skills Independent enterprises would require that the value of each participant's proportionate share of the actual overall contributions to the arrangement is consistent with the participant's proportionate share of the overall expected benefits to be received under the arrangement. To apply the arm's length principle to a CCA, it is therefore a necessary precondition that all the parties to the arrangement have a reasonable expectation of benefit.

The next step is to calculate the value of each participant's relative contribution to the joint activity, and finally to determine whether the allocation of CCA contributions (as adjusted for any balancing payments made among participants) accords with their respective share of expected benefits. It should be recognised that these determinations may bear a degree of uncertainty. The potential exists for contributions to be allocated among CCA participants so as to result in an overstatement of taxable profits in some countries and the understatement of taxable profits in others, measured against the arm's length principle. For that reason, taxpayers should be prepared to substantiate the basis of their claim with respect to the CCA.

The guidelines set out details of documentation to be prepared in connection with a CCA, referencing detailed documentation provisions in Chapter V of the TPG.