

## Answer-to-Question-\_1\_

(TPG = Transfer pricing guidelines)

1) The glossary in the TPG provides a definition of associated enterprises, in turn it relies on the conditions as per Article 9 of the OECD MTC. The TPG describes it 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."

The first step would be to identify the relevant transactions taking place between the associated enterprises.

NewvaniaCo:

- Licenses its IP\* to OldvaniaCo.
- Provides services ('backoffice', e.g. marketing, HR, IT, finance etc.) to all associated enterprises (OldvaniaCo, PalamariaCo, ArchipeliaCo).
- Provides, via an independent party, warehousing and transportation, to own retail stores in country.
- To a degree, undertakes marketing activity for OldvaniaCo. Although, OldvaniaCo does some of its own marketing given the local market differences.
- Loan to OldvaniaCo, \$100m at 9%.
- Undertakes R&D activity for the Group.
- Provides guidance\*\* to PalamariaCo on manufacture quantities, types etc. in exchange for a charge.
- Provides IP\*\*\* in exchange for royalty/licence fee to PalamariaCo.
- Provided a loan to PalamariaCo at 3% above cost of borrowing (currently 7%)
- Tasks ArchipeliaCo to source apps for the group. (See \*\*\*\* under delineated transaction for ArchipeliaCo).

OldvaniaCo:

- Licenses its IP\* to from NewvaniaCo.
- Receives services, ('backoffice', e.g. marketing, HR, IT, finance etc.), from NewvaniaCo.
- To a degree, receives some marketing from NewvaniaCo (given it, itself, undertakes some marketing to account for local market differences).

- Purchases finished products from PalamariaCo.
- Loan from NewvaniaCo, \$100m, at 9%
- Receives benefit of R&D activity from NewvaniaCo.
- Purchases apps from Archipelia to sell on.

PalamariaCo:

- Receives services, ('backoffice', e.g. marketing, HR, IT, finance etc.), from NewvaniaCo.
- Sells finished products to OldvaniaCo. - Receives benefit of R&D activity from NewvaniaCo.
- Receives guidance from NewvaniaCo on manufacture quantities, types etc.
- Received IP\*\*\* use from NewvaniaCo in exchange for royalty/licence fee to PalamariaCo.
- Received a loan to NewvaniaCo at 3% above cost of borrowing (currently 7%).
- Purchases apps from Archipelia to sell on.

ArchipeliaCo:

- Sources online apps for the group to purchase, NewvaniaCo has the final say. These downloaded from the website/app store owned and operated by NewvaniaCo.\*\*\*

\*In this case, I've assumed IP to be trademarks/tradenames etc.

\*\*Assumed there is a charge for this level of support provided to PalamariaCo, or is reflected in the TP methodology utilised.

\*\*\*Although we know that IP is provided to PalamariaCo, we don't know if a licence fee/royalty is charged. So assumed there is a licence fee/royalty.

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Answer-to-Question\_\_1 - (2)\_\_\_

A functional analysis helps to identify the key value drivers for the group. The TPG glossary describes it as: "The analysis aimed at

identifying the economically significant activities and responsibilities undertaken, assets used or controlled, and risks assumed by the parties to the transactions".

The Functional analysis (FAR) is one of the steps in the comparability factors (TPG Chapter 1 para 1.36) and also features again the comparability analysis (TPG Chapter 3, para 3.4)

Key:

x - Routine

xx - Important

xxx - Key

	Newvania Co	OldvaniaCo	PalamariaCo	Archipel iaCo		Notes
<b><u>Functions</u></b>						
IP	xxx	xx	xx	xx		
R&D	xxx			x		
Trademark	xxx	xx	xx			
Sourcing of 3rd party apps	xx			xxx		
Intra-group loans	x	xx	xx			
Group services	xx	xx	xx	xx		
Characterisation	Entrepeneur of the group	Sales agent	Sales agent /contract manufacturer	Sales agent		
Man						
Hosting services	xx					
Identifying app developers				xxx		
<b><u>Assets</u></b>						
Employees	x	x	x	x		
Offices	xx	x	x	x		Important in NewvaniaCo , given they have premium offices,

						so there would ordinarily be a reason for this.
transport						
customer lists						
machinery						
Own retail stores	xx	xx	xx			
manufacturing			xxx			
Plant and machinery			xxx			
Market	xx	xx				
Relationship with banks	xx					
Computer servers	xx					
office furniture	x					
Relationship with app developers				xx		
<b>Risks</b>						
Obsolence	xx					
Market tastes (given it is a premium product)	x	x	xxx	xx		This is considered a routine in NewvaniCo and OldvaniaCo , given the moving trend towards teenagers being discouraged from owning smartphones - and given that these two are developed markets, this is likely to

						<p>be a greater risk.</p> <p>Further this is an important risk in PalamariaCo and Archipelai Co's countries as those are emerging economies and given the salaries of the employees, the disposable incomes are likely to be lower.</p>
Loan		x	xx			<p>There is a loan risk for Archipelai Co, given that it is 3% above NewvaniaCo's borrowing costs.</p>
FX	x	xx	xx	xx		
Inventory risk	x	x	x	x		

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Answer-to-Question-\_1 (3)\_\_\_

We don't have the full details of the turnover on an entity basis.

Generally, it would be beneficial to undertake functional interviews.

These should have a sponsor (from the business), a project manager, a lead 'questioner' and a note taker. These can be time consuming and decision are required as to the level of resource to dedicate.

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Answer-to-Question-\_1 (4)\_\_\_

The TPG (Chapter 2) identifies 5 methods. These are comprised of traditional transaction methods and transactional profit split methods. The UNTPM identifies a 6th method, for commodities. This last method is not relevant here.

The 5 TPG methods are:

- Comparable uncontrolled price, CUP, (traditional transaction method)
- Resale price method (traditional transaction method)
- Cost plus (traditional transaction method)
- Transactional net margin method, TNMM, (transactional profit method)
- Transactional profit split method/residual profit split method (transactional profit method)

Whilst the TPG no longer has a hierarchy, the preferred method (certainly from tax authority point of view) tends to be the CUP.

- In relation to the support services provided across the group, by NewvaniaCo, (marketing, finance, IT, HR etc.), There doesn't appear to be any internal CUPs available. A view should be taken if there are any external CUPs available, or indeed in respect of this particular service. If an external CUP exists and it relates to a comparable uncontrolled transaction, then this should be the preferred transfer pricing approach. Taking the CUP approach does permit some adjustments to be made to the comparable uncontrolled transaction, to bring it inline with transaction under review. If the adjustments become excessive, then it is likely to no longer be comparable. The facts do not suggest any CUPs exist, even if it would quite possibly be the most accurate.

For these services provided to the associated enterprises, a cost plus approach could be used. This would be straightfoward, NewvaniaCo could identify the costs incurred in relation to these support services and apply that. This could include a combination of direct and indirect method. The direct method of allocation, identifies the services provided to the entities. The indirect method would take the remain (indirect costs) and utilise allocaiton keys for these. An allocation key could consist of turnover, headcount (for HR), number of computers (for IT licences) etc. If Safe Harbour exists (TPG Chapter 4, E1 onwards), then that could be another more straightforward approach. Typically, safe harbours enable back office/support services to be charged at Cost+5%.

For the intra-group loans, from Newvania to OldvaniaCo and PalmariaCo. If NewvaniaCo, does not have any specific input into these these these should be charged across with no market. If NewvaniaCo does have an input in these and obtains a lower interest rate for the entities than they would obtain directly, then a fee could be levied base on the spread (between that available to the entity and one that NewvaniaCo could facilitate). Although, no charge should be made where the gurantee is implicit, as opposed to explicit guranatee (where a charge could be utilised).

For the manufacturing undertaken by ArchipeliciaCo, NewvaniaCo, could reward it on the basis of either cost plus or TNMM. For the TNMM, an operating margin or a return on assets Profit Level Indicator could be utilised.

For the sales of finished goods between PalmariaCo and OldvaniaCo, a cost plus, Resale method or a TNMM could be utilised. The resale method (not discussed above), TPG chapter 2, is where a "margin representing the amout out of which a reseller would seek to cover its selling and other operating expenses and, in light of hte funciton performed (taking into account assets used and risks assumed), make an approapriate profit". The group entities would know the prices at which the goods are sold to the end customer (as that will not be a controlled transaction) take a view on how much it would require as a gross margin, making and adjustment, with the left over amount being the transfer price.

Use of any IP between NewvaniaCo and PalamariaCo, should be on a cost plus basis. Use of any IP from NewvaniaCo to the other entities should also be on a cost plus basis.

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Answer-to-Question-\_\_2 (1)\_

The characterisation of an entity would help support in the caparability exercise and thus identifying the most appropriate transfer pricing methodology to utilise.

NewvaniaCo: The Entreprenur/decision making entity of the group. This entity provides the direction on what PalamariaCo should produce, quantities etc. Therefore it takes the most risks in the group.

OldvaniaCo: Sales entity/limited risk distributor. Whilst it does take some risks in that it holds 3 months of stock, some local marketing and sales to some 3rd parties, it ultimately relies on what NewvaniaCo has informed PalmariaCo to produce. I would assume that NewvaniaCo. takes a view on how sales are progressing in OldvaniaCo and decides on adjustments to its direction to production schedules to ParlmariaCo.

PalmariaCo: with regards to manufacturing - Contract manufacturer and limited risk distributor. It obtains the direction and IP from NewvaniaCo to undertake its manufacturing activity. With regards to sales to unrelated parties. a limited risk distributor - Similar to OldvaniaCo for those reasons.

ArchipeliaCo: Sales and purchasing agent. It identifies the apps to purchase but operates under final sign-off from NewvaniaCo.

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Answer-to-Question-\_2 (2)\_\_\_

When considering the arm's length principle (ALP) a view should be taken on how much risk the entities undertake. The greater the risks assumed and borne, the greater the profit/reward (or even loss). The TPG Chapter 1 (para 1.60) details the factors for analysing risk. These are (briefly):

1. Identify economically significant risks with specificity.
2. Determine how specific economically significant risks are contractually assumed, by associates, under the relevant terms.
3. Utilise a functional analysis on how the parties operate.
4. Interpret steps 2 - 3 and whether the associated enterprises actually follow the contractual terms and whether the party assuming the risk exercises control and has the financial capacity to do so.
5. Where the party does not control the risk or have the capacity to do so, reallocate the risk.
6. The actual transaction, as accurately delineated, should be priced.

As mentioned above, the entrepreneur of the group would command a greater operating margin (NewvaniaCo.) as it does. The entities assuming smaller/reducing amounts of risk will command a reduced operating margins. Therefore, it is unusual for the operating margins, when applying the risk analysis for the group, to vary, with those bearing greatest risk (with the financial capacity to do so) being rewarded a higher profit share (or greater loss).

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Answer-to-Question-\_2 (3)\_\_\_

The comparability exercise should comprise of the identifying the comparability factors, once identified, undertaking a comparability analysis. The comparability factors are set out in the TPG Chapter 1



(para 1.36), these are:

- Identifying the contractual terms of the transaction
- The Function performed, by each party to the transaction, taking into account the assets used and risks assumed.
- Characteristics of the property transferred or services provided.
- Economic circumstances of the parties and their markets.
- The business strategies pursued.

Following the above, the comparability analysis should be performed, this is set out in the TPG, Chapter 3, and the 9 steps are at para 3.4. The 9 steps are:

1. Years to be covered
2. Broad analysis of the taxpayer's circumstances.
3. Understanding the controlled transaction and the Functional Analysis.
4. Identify any internal comparables
5. Determine of available sources of information on external comparables.
6. Select most appropriate transfer pricing method, depending on the method utilised.
7. Identify potential comparables, with reliance on the functional analysis.
8. Undertake comparability adjustments.
9. Interpretation and determination of the arm's length remuneration.

Applying this to ArchipelicaCo. we don't have any details of the operating margin that it achieves or indeed if it is being appropriately remunerated. Undertaking the above would assist NewvaniaCo. in deciding how to reward ArchipelicaCo. Moreover, the tax rate in Archipelica is 5%, as a result MNEs are able to utilise transfer pricing to assist with tax planning and move income to lower tax jurisdictions. It should be observed that it has 100 employees, whether this is sufficient for the functions it undertakes, assets it utilises and risks it assumes would be assessed following a comparability exercise.

The factors for analysing risk may also be helpful. These are at TPG Chapter 1 (para 1.60) details the factors for analysing risk.

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Answer-to-Question-2\_2(4)\_\_\_

The obvious tax concern would be whether NewvaniaCo. is over rewarding ArchipelicaCo given ArchipelicaCo derives 50% gross margin from the sales of apps, despite the sign-off and input required from NewvaniaCo directors.

The loan to OldvanieCo could raise concerns. This is fixed at 9% and the current cost to NewvaniaCo. (based on the information) is 7% variable.

If this increased, NewvaniaCo. could be subsidising the loan. This is compounded by the fact that the loan to PalmariaCo. has an interest rate of 3% in excess of NewvaniaCo's. costs.

NewvaniaCo. tax authority may assert that ArchipeliaCo. has a permanent establishment (PE) in NewvaniaCo. They are associated enterprises (Article 9 OECD MTC) but the conditions of Article 5 (OECD MTC) could also be met. ArchipeliaCo, has use of an office, staff routinely travel to NewvaniaCo. if this amounts of 183 days in a fiscal year then the PE argument could become stronger, those staff rely on the direction of NewvaniaCo directors so sign-off.

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Answer-to-Question-\_4\_\_

The TPG Chapter 9 condisders Business Restructurings. Article 9 of the OECD MTC applies. Moreover Article 9, OECD MTC would also be applicable.

A very brief pre and post restucturing funtional analysis would be:

	Nutrition Corp (pre-restructure)		Nutritio n Corp (post-restructure)	Nutritio n Sub A (post-restructure)	Nutritio n Sub B (post-restructure)	Nutrit ion Sub C (post-restru cture)
<b>Functions</b>						
R&D	x			x		
manufacturi ng	x					
distrubtion related activities	x		x			
Sales & marketing	x				x	
Support services	x					
<b>Assets</b>						
Staff	x			x	x	
Manufacturi ng facility	x			x		
IP	x					x
Loan to group member			x			

<b>Risks</b>						
Market	x			x		
loan from group member					x	

The above shows the functions, assets and risks of NurtritionCorp are spread to other group members, holding limited functions itself.

The delineated transaction are (post restructure):

Nurtrition Corp:

- Provides distribution related activities to associated enterprises.
- Provides a loan to Nurtrition Sub B at a rate of 12%.
- Pays a royalty to Sub C.

Nurtrition Sub A:

- Performs the manufacturing for the associated enterprises.

Nutrition Sub B:

- Performs the services across the group (previously undertaken by Nutrition Corp).
- Pays interest to Nutrition Corp at 12%

Nutrition Sub C:

- receives royalties from distribution entities.

The transfer pricing risks are:

- The amount Nurtrition Corp should be remunerated for the loss of its IP. It could also give rise to a capital gain in Nutrition Corp's home country.
- Given Nutrition Corp has had its employees transferred to Nutrition Sub A and Sub B, in other countries, whether redundancies should be reimbursed for those individuals who cannot move to other countries.
- The royalty amounts paid would also give rise to concerns. These were not in existence before the restructure.
- The loan advanced to Sub B, at 12%. Is Nutrition Corp receiving the correct value. From Sub B's point of view, is it overpaying for the loan? Especially given the DTA on reducing the withholding tax on interest.

Other considerations include:

- Should compensation be paid for loss of profits for NutritionCorp.
- Whether the post-restructure could give rise to Exit Charges in country X.
- Controlled foreign companies (CFCs).
- General anti-abuse rules.
- VAT/GST.
- Capital gain considerations for the transfers of IP.

- Permanent establishment concerns.

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Answer-to-Question-\_6 (1)\_\_\_

The TPG Chapter 7 considers intro group services.

The AOA takes a two step approach. The benefits test and then the arm's length price.

Under the benefits test: has a service been provided, and would an independent entity pay for that service. If answer to either is 'no' then then intra group service charge should be levied. Intra-group services could also benefit from Safe Harbours and considered to be Low Value Added Services, these are typically charged at cost plus 5%.

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Answer-to-Question-\_6\_(2)\_\_\_

The TPG Chapter 4, E.1. considers safe harbours. Para 4.102, discusses safe harbours in that they are applied "to a defined category of taxpayers or transactions", helping to bring simplification from certain obligations.

Separately, tax incentives could comprise of Patents and R&D expenditure. Income derived from patents could attract a lower tax rate. R&D expenditure could be 'inflated' as a multiple of that actually incurred, via permission from the tax authority.

	Taxpayer advantages	Taxpayer disadvantages	Tax authority advantages	Tax authority disadvantages
Safe harbour	Simplification in application. Typically permit support functions to be marked up at Cost plus 5%	Could potentially disincentivise the controlling of costs	Helps to focus scarce resource on most riskiest transactions.	Could result in double non-taxation.
	Provide relative certainty on	Could lead to income being	Applied to low value adding	Reduction in tax receipts.

	the treatment of transactions.	'deflated'	services, that potentially could be further under-rewarded were it not for a safe harbour.	
	Reduction in compliance costs.	Could increase risk of double taxation.	Assists with less developed countries to free-up resource.	Encourage tax planning
Tax incentives	Drive innovation		Encourage additional tax receipts	less developed countries could lose out.

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Answer-to-Question-\_8 (1)\_\_\_

The TPG glossary provides an definition of an APA as "an arrangement the determines in advance of controlled transactions, an appropriate set of criteria ...for the determination of transfer pricing for those transactions over a fixed period of time. An advance pricing arrangement may be unilateral involving once tax administration and a taxpayer, or mulilateral invoving the agreement of two or more tax administrations". Further details of APAs is withis the TPG at Chapter 4, F.1. onwards.

Yes an APA should be sought. This would provide certainly, subject to certain obligations and filing requirements, to Surfland. An APA should be sought in both jurisdictions (bilateral/multilateral) as that would provide most certainty.

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Answer-to-Question-\_8\_(2)\_\_\_

The advantages of an APA include:

- Certainty to Surfland, in this case, that the tax authorities are aware of the transactions, prices paid and have provided 'certainty', subject to requirements, that further action will not be undertaken for the duration of the APA.

- Provides certainty to the tax authority on the nature and value of the transaction, enabling them to give an agreement, subject to parameters set down.

- Enables tax authorities to use their resource elsewhere, on more riskier transactions.

- Could help prevent time-consuming and costly compliance checks for both the taxpayer and tax authority.

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Answer-to-Question-\_8\_(3)\_

The APA would cover:

- The transaction under review.
- The prices to be paid, or income to be received.
- The comparables relied upon,
- the market operated in.
- the geographical location.

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Answer-to-Question-\_8\_(4)\_

No.

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Answer-to-Question-\_8\_(5)\_

Unilateral APAs are undertaken with one tax authority, where as bilateral are undertaken with two (or more) tax authorities. Unilateral APAs are risky, in that the other tax authority does not necessarily have to accept the agreemetn. As a result Bilateral APAs are preferred.