THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

June 2022

MODULE 3.03 – TRANSFER PRICING OPTION

SUGGESTED SOLUTIONS

PART A

Question 1

Part 1

Candidates are expected to identify the comparable uncontrolled transactions between associated enterprises in the Machine Group based on the facts extracted from the Country-by-Country documentation. Limited information is available and it is noted that in practice, the substance of the commercial or financial relations between the associated enterprises would need to be considered. This includes analysing the written contracts and analysis of the conduct of the parties and other relevant characteristics of the transactions.

Better candidates may for example, refer to D.2. Of Chapter 1 of the 2017 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD TP Guidelines).

Alpha

- Sale of finished goods to Beta;
- Sale of finished goods to Delta;
- Provision of services (including management, administration, IT, accounting, marketing and forecasting to Beta);
- Provision of services (including management, administration, IT, accounting, marketing and forecasting to Gamma);
- Provision of services (including website hosting/maintenance, management, administration, IT, accounting, marketing and forecasting to Delta);
- Loans funds to Beta;
- Loans funds to Gamma;
- Loans funds to Beta;
- Provides intellectual property to Gamma, including manufacturing know how; and
- Receipt of contract manufacturing services from Gamma.

Beta

- Purchase of finished goods from Alpha;
- Receives services (including management, administration, IT, accounting, marketing and forecasting from Alpha; and
- Receives loan funds from Alpha.

Gamma

- Receives loan funds from Alpha;
- Receives services (including management, administration, IT, accounting, marketing and forecasting from Alpha);
- Receives intellectual property from Gamma, including manufacturing know how; and

- Provides contract manufacturing services to Gamma (including possibly logistical functions to Alpha, Beta and Delta).

Delta

- Purchase of finished goods from Alpha;
- Receives services (including website hosting/maintenance, management, administration, IT, accounting, marketing and forecasting) from Alpha; and
- Receives loan funds from Alpha.

Part 2

Chapter 2 of the OECD TP Guidelines covers transfer pricing methods. Selection of the most appropriate method depends on the facts and circumstances of the particular case (2.2 of OECD TP Guidelines).

It is acknowledged that facts provided in the question are limited and in order to recommend the most appropriate transfer pricing method, further information would need to be obtained from Machine Group, including identifying the commercial or financial relations between associated parties.

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). They should indicate which one (or ones) is the 'most appropriate' based on the facts provided, rather than making general statements without having regard to the facts.

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.

Based on the facts available in relation to Machine Group, a CUP may be appropriate in relation to the loan transactions, based on the interest rate at which Alpha borrows from independent parties.

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 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.

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.

Based on the limited facts provided for Machine Group, it is unlikely that the resale price method should be applied.

Cost plus method

The cost plus method starts with the cost incurred by the supplier of property (or services) in a controlled transaction (between associates) for property transferred or services provided to an associate. An appropriate cost plus mark-up is then added (having regard to the facts and circumstances after undertaking a comparability/benchmarking analysis) to this cost, to determine an appropriate arm's length margin based on the functions performed and the market conditions.

What is arrived at after adding the cost plus mark up to the costs should be regarded as an arm's length price. This method probably is generally most useful in relation to semi-finished goods sold between associates, such as joint facility agreements or long-term buy-and-supply arrangements, or where the controlled transaction is the provision of services.

In the case of Machine Group, this method could apply to the provision of services (management, administration, IT, accounting, marketing and forecasting) provided by Alpha to subsidiaries or associated enterprises. Further, it could also apply to the contract manufacturing performed by Gamma for the benefit of Alpha.

In relation to the services, it's possible that Machine Group has a centralised operating model based on Alpha undertaking a significant number of services on behalf of (and possibly for the benefit of) associated enterprises. Refer to B.1.5 of the OECD TP Guidelines.

Better candidates will refer to Chapter VII of the OECD TP Guidelines regarding intra group services. For example, Machine Group may be eligible for the simplified determination of arm's length pricing for low value intra-group services provided by Alpha.

Based on paragraph 7.61 of the OECD TP Guidelines, a profit mark-up should apply to all costs in the pool with the exception of pass through costs (refer also to paragraphs 2.99 and 7.34). In order to satisfy the requirement for low value services which are of a supportive nature, the services should not be considered to be part of Machine Group's core business, they should not involve 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 details activities which do not qualify for the simplified approach. Paragraph 7.45 provides a number of examples which are likely to meet the definition of a low value service including a number which are of the type undertaken by Alpha. The mark-up should be 5% of the costs, determined based on D.2.2.

Sufficient information is not available to determine if a CUP may be appropriate in relation to the sale of product. The sales to associates may not be at the same point in the value chain as the sales that it makes to independent parties. They also may not be in comparable markets.
Transactional net margin method (TNMM)

The TNMM considers the net profit relative to an appropriate base (such as costs, sales or assets) that an MNE realises from a controlled transaction. Thus, the TNMM is a similar approach 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 benefit of the method is net profit indicators are less affected by transactional differences than is the case with price, as applied in the CUP method. Also, net profit indicators may be more appropriate to account for functional differences between the controlled and uncontrolled transactions than gross profit margins.

The method is one-sided, so it is necessary to examine a financial indicator for only one of the associated enterprises (the tested party) which is a benefit when one of the entities to the transaction is complex and may have many interrelated activities or some information may not be available through lack of information.

One downside is 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. Certain information required 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.

A TNMM may be the most appropriate method to apply to Beta, Gamma and Delta based on their activities and functions (Alpha and Delta appear to undertake sales, distribution and marketing activities and Gamma is predominately a contract manufacturer) as long as appropriate comparables can be identified. An appropriate Profit Level Indicator may be EBIT/Sales margin, possibly in the range of 2-4%. However, a functional analysis and benchmarking exercise should be undertaken to determine an appropriate arm's length price or a range of arm's length prices.

A TNMM may also be an appropriate methodology for services undertaken by Alpha for associated enterprises. A TNMM based on a cost plus basis, would apply an arm's length margin to the cost base of chargeable services.

<u>Transactional profit split method</u>

This 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. It splits combined profits (or losses) between the associated enterprises on an economically valid basis per an arm's length agreement.

A primary strength of the method is that it can apply to 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.

A weakness in the method is that detailed financial and other information of associates are required in order to identify the operating expenses to allocate.

In relation to the profit split method, paragraph 6.205 provides 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 Machine Group, it is unlikely that the profit split method should apply as Machine Group retains ownership of the intellectual property, which appears to be driving the profits. Further, Machine Group does not appear to undertake a highly integrated business model.

It is noted that R&D is undertaken by Alpha, but this should not be charged to associates as Alpha retains ownership of Machine Group's intellectual property. Alpha should be entitled to any entrepreneurial profits as it undertakes DEMPE functions.

Part 3

Candidates may raise a range of issues. However, tax administration of Alpha may have concerns with the following:

Delta

Operating margin of 50% which is substantial (and greater than Alpha which owns the group's intellectual property) when it does not appear to undertake significant functions or own material assets.

Delta appears to operate a low cost business model with Alpha maintaining its website, with 3 employees.

Delta purchases finished goods from Gamma at cost price, which undertakes contract manufacturing on behalf of Alpha. Based on the contract, Delta should likely acquire finished goods at an arm's length price rather than cost price, which is highly unlikely to be an appropriate price.

Delta appears to sell to end consumers (trades people), rather than to retailers as other associates in the group – thereby possibly making a higher margin.

Tax rate of Delta, being 5% is materially lower than Alpha and other jurisdictions.

Gamma

Operating margin of 10% when undertaking contract manufacturing for Alpha.

Alpha provides the intellectual property for manufacturing know-how.

Gamma should earn an arm's length margin and 10% may be excessive.

For both taxpayers, a comprehensive functional analysis and comparability analysis should be undertaken to determine compliance with the arm's length principle.

In relation to use of Country-by-Country documentation for audit purposes, C.3. Of Chapter V provides guidance on the Country-by-Country Reports. Paragraph 5.25 specifies that:

"… the Country-by-Country Report should not be used as a substitute for a detailed transfer pricing analysis of individual transactions and prices based on a full functional analysis and a full comparability analysis. The information in the Country-by-Country Report on its own does not constitute conclusive evidence that transfer prices are or are not appropriate. It should not be used by tax administrations to propose transfer pricing adjustments based on a global formulary apportionment of income."

Question 2

Part 1

Chapter V (C) of the OECD TP Guidelines set out the three-tiered approach to transfer pricing documentation, consisting of:

- A master file containing standardised information relevant for all members of the Machine Group;

- A local file referring specifically to material transactions of each member of the Machine Group; and

- A Country-by-Country Report (CbC Report) containing certain information relating to the global allocation of the Machine Group's income and taxes paid, along with certain indicators of the location of economic activity within the group.

Further details of each of the tiers is set out below:

Master file

This should provide an overview of Machine Group's business, including the nature of its global business operations, its overall transfer pricing policies and its global allocation of income and economic activity.

It should include:

- Machine Group's organisational structure;
- Description of Machine Group's business;
- Machine Group's intangibles;
- Machine Group's inter company financial activities; and
- Machine Groups' financial and tax position.

Annex 1 to Chapter V of the OECD TP Guidelines provides further detail, which some candidates may refer to.

Local File

This proxies more detailed information relating to specific inter-company transactions. A file should be prepared for each jurisdiction that Machine Group operates in.

This would include:

- Information relevant to the transfer pricing analysis related to material transactions taking place between the local entity and associated enterprises in different countries;

- Relevant financial information regarding material transactions;

- Comparability analysis; and

- Selection and application of the most appropriate transfer pricing method.

Annex II to Chapter V of the OECD TP Guidelines refers to additional detail.

<u>CbC Report</u>

Machine Group should include:

- Aggregate tax jurisdiction-wide information relating to the global allocation of the income, the taxes paid and indicators of the location of economic activity among tax jurisdictions in which Machine Group operates; and

- Listing of all the Constituent Entities for which financial information is reported including the tax jurisdiction of incorporation where it is different to tax jurisdiction of residence, and the nature of the main business activities carried out.

Annex III to Chapter V of the OECD TP Guidelines provides more granular detail.

<u>Parts 2 and 3</u>

A functional analysis is a key aspect in order to apply the arm's length principle.

It is a key step of considering the economically relevant characteristics or comparability factors to be identified in the commercial or financial relations between the associated enterprises to accurately delineate the actual transaction.

D.1.2 of the OECD TP Guidelines set out that 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. However, prior to undertaking a functional analysis, the commercial or financial relations between associated parties should be examined.

It is acknowledged that limited information is available in the facts provided and candidates may need to make assumptions given they are unable to interview staff of Machine Group, access additional documentation and industry documentation.

The following provides a number of key functions, assets and risks which may be identified based on the facts.

<u>Alpha</u>

Functions:

- Sales and marketing;
- Distribution of goods;
- Strategic direction;
- Research and development;
- Management services;
- Administrative support;
- Information technology;
- Accounting;
- Demand forecasting;
- Technical assistance;
- Manufacturing for group; and
- Treasury and finance .

Assets:

- Intellectual property (patents, trade marks, trade names, brand names and manufacturing know how);

- Office building;

- Property plant and equipment (furniture, information technology and motor vehicles); and

- Key staff.

Risks:

- Market risk;
- Manufacturing risk;
- Financing risk;
- Credit risk;
- Inventory risk;
- Capital investment risk;
- Warranty risk; and
- Foreign exchange risk (assumed as not specified in facts).

Classification: entrepreneur and intellectual property owner through undertaking research and development and setting the strategic direction of the group

Beta

Functions:

- Marketing and distribution in local market and neighbouring countries.

Assets:

- Office building (leased);
- Property, plant and equipment (motor vehicles, IT equipment and furniture); and
- Staff.

Risks:

- Inventory;
- Market risk; and
- Credit risk.

Classification: limited risk distributor executing local marketing strategy for region

Gamma

Functions:

- Contract manufacturing;
- Logistics; and
- Sourcing of raw materials.

Assets:

- Manufacturing premises;
- Property, plant and equipment (manufacturing equipment, motor vehicles, IT equipment, furniture); and
- Staff.

Risks:

- Obsolescence of manufacturing equipment;
- Health and safety of operation of manufacturing equipment; and
- Logistic risk.

Classification: low risk contract manufacturer undertaking logistics

<u>Delta</u>

Functions:

- Sales and distribution through online digital platform; and
- Logistics.

Assets:

- Staff (limited); and
- Computer equipment.

Risks:

- Credit card fraud.

Classification: limited risk operator of online platform for retail customers.

PART B

Question 3

Candidates should note that a functional analysis identifies 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.

Candidates should give consideration 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.

Better candidates will identify that 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.

Candidates should make reference 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.

Candidates should provide consideration of the impact of the changes to functions, assets and risks of the entities for the Surfco Ltd group by examining the pre and post business restructure. They will identify the arm's length nature of the overall restructure as well as the individual transactions between associated enterprises having regard to the application of the facts in the question.

Pre-Restructure

Associated Entity within the MNE group	Functions	Assets	Risks	Characterisation
Surfco Ltd (group head company)	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
Surfco Sub1	Sales/marketing Retailing Procurement Demand planning Training	Retail stores Warehouse Staff	Market risk	Retailer/distributor

Post-Restructure – the inclusion of the following associated entities into the Surfco Ltd multinational group

Associated Entity within the MNE group	Functions	Assets	Risks	Characterisation
Surfco Ltd	Sales/marketing Retailing Procurement Demand planning Training	Retail stores Warehouse Staff	Market risk	Retailer/distributor
Surfco Sub 1	Intellectual property holding company	Staff Intellectual property	Intellectual property risk	Legal owner of intellectual property
Surfco Sub 2	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

In terms of the implications/risks of the business restructure, candidates may highlight the following having regard to the facts:

Transfer of intellectual property from Surfco Ltd to Surfco Sub1:

- Has there been an arm's length compensation for the transfer of the intellectual property?
- Valuation issue in relation to the arm's length compensation for transfer of intellectual property.

Loan between associated enterprise – Surfco Ltd and Surfco Sub1:

- Are the terms and conditions of the loan arm's length?
- Commercial purpose of the loan?

Shift of manufacturing operations, creation of a new associated enterprise (Surf Subco2) in a country with a lower headline corporate income tax rate (and tax exemption). Change to the related party purchases and sales transactions:

- 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?
- Buy-out/exit payments?
- Loss of profit making potential.
- Commercial and economic rationale for entering into business restructure having regard to the arm's length principle.
- What options were realistically available for all entities involved in the business restructure?
- The legal form of the transaction relative to the economic reality of the transaction.

Continuation of a significant marketing function performed by Surfco Ltd:

- Examination of the functions, assets and risks of each entity in the group and confirmation of characterisation relative to the purported business restructure.

Better candidates will reference the 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?
- Was 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.

Better candidates may make reference to the OECD Transfer Pricing Guidelines (2017), Chapter II: Transfer Pricing Methods, as well as potential comparability issues.

Question 4

Candidates should make reference to article 5 (Permanent Establishment), and commentaries, of the OECD Model Tax Convention on Income and Capital (2017).

The facts applicable to the Apollo group should be applied in relation to the Article 5 of the OECD Model Tax Convention (2017).

Permanent establishment issues that may be raised by a tax administration conducting a review of the Apollo Group that candidates may describe include:

- Candidates may argue that Apollo Ltd has a fixed place of business permanent establishment in Occorian through the operation of a potential office, branch, factory or workshop; this would be evidenced through functions, assets and risks relevant to the operation of the project. The place of management may also be conducted in Occorian given the existence of key staff including project managers; Article 5(1 & 2).

- A fixed place of business permanent establishment may also be created by the independent company.

- The property development project (construction of a luxury resort) being undertaken by Apollo Ltd in Occorian may give rise to a permanent establishment having regard to Article 5(3); a project lasting more than 12 months. The article and commentary notes circumstances where contracts and work conducted within the project may be split up. Candidates may identify that this is the case with the Apollo group in terms of staff employed by Apollo Ltd completing work in Occorian for periods no longer than one month at a time; that may relate to separate projects/activities contributing to the holistic project.

- Candidates may suggest that the anti-fragmentation rules, noting Article 5(4), may apply to the Apollo group. The facts state that staff employed by Apollo Ltd complete work in Occorian on a ‘fly in fly out’ basis for a period of no longer than one month at a time. This may result in the overall combination of activities carried out in Occorian resulting in a permanent establishment for Apollo Ltd. This includes activities that may be preparatory or auxiliary in nature that may not be taken advantage of given the cohesive operating business overall.

- A dependent agent permanent establishment may be created with reference to Article 5(5) if decision makers of Apollo Ltd sign contracts relevant to the project conducted in Occorian (habitually concluded routinely).

- A services permanent establishment may need to be considered, applicable to the staff employed by Apollo Ltd performing work in Occorian.

Better candidates will raise potential transfer pricing issues in relation to the arrangement of Apollo Ltd’s functions performed on behalf of an independent company. BEPS action item 1 – tax challenges arising from digitalisation; this has evolved into the work of OECD’s Pillar work. The registration of a website and social media platforms in Occorian relative to functions performed by Apollo Ltd. Remuneration of each entity in each jurisdiction relative to the functions and the booking of the sales of customers ordering online from the digital platforms would need to be examined. A permanent establishment may also arise from this arrangement.

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).

Candidates should reference 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 being conducted by Apollo Ltd in Occorian would need to considered when allocating associated profit/loss.

PART C

Question 5

Candidates should define a Cost Contribution Arrangement (CCA), its application and highlight the advantages and disadvantages of a CCA, using examples.

Reference is made to Chapter VIII of the OECD TPG.

A CCA is defined as a contractual arrangement among business enterprises to share the contributions and risks involved in the joint development, production or the obtaining of intangibles, trade assets or services with the understanding that such intangibles, tangible assets or services are expected to create benefits for the individual businesses of each of the participants. A CCA does not require the participants to combine their operations in order to exploit the outcome from the CCA or to share the profits or revenue. Rather, participants exploit their interest in the outcomes of the CCA through their individual businesses.

The proportion of actual overall contributions to the arrangement should be consistent with the participant's proportionate share of the actual overall contributions to the arrangement and benefits to be received. A participant must be assigned an interest or rights in the intangibles, tangible assets or services that are the subject of the CCA and have a reasonable expectation of being able to benefit from that interest or those rights.

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

Some key advantages of a CCA include:

- Exploiting economies of scale and global corporate efficiency for commonly required services.
- Reducing duplication within an MNE group.
- Increasing operational effectiveness through shared activities and synergies within the MNE group.
- The sharing of risks among the CCA participants.
- Exploiting the knowledge of the participants through the sharing of knowhow and best practices.

Some circumstances whereby a CCA may not be appropriate includes where there is not a proportionate sharing of contributions and benefits, no intangible assets or research and development is present in the MNE, and there is not a clear demonstration of control and ownership of risk or decision making.

Question 6

Candidates are expected to explain the benefits and costs of transfer pricing documentation from the perspective of both a tax administration and MNE. This is in the context of risk assessment and risk management.

Reference is made to Chapter V: Documentation of the OECD TPG.

Three key objectives of transfer pricing documentation are:

- Taxpayers give consideration to transfer pricing requirements when establishing the pricing of related party transactions when preparing their tax return.

- Provides tax administrations with information for transfer pricing risk assessment purposes.

- Provides tax administrations with information for transfer pricing audit purposes.

Section B in Chapter V of the OECD TPG elaborates on each of these objectives.

The preparation of detailed, contemporaneous documentation by a taxpayer, has a number of advantages including:

- Demonstrating the transfer pricing positions reached have been carefully considered and articulated having regard to the arm’s length principle.

- Potential prevention of cost and time associated with transfer pricing audits by tax administrations.

- Reduces the risk of double taxation.

- Reduction in penalties in the event of transfer pricing audit adjustments by tax administrations.

- Contribution to the corporate governance of the MNE as well as good tax risk management.

However, it is noted that preparation of transfer pricing documentation by a taxpayer involves costs, time constraints, and competing demands for the attention of relevant personnel. It is therefore important to keep documentation requirements reasonable and focused on material transactions in order to ensure mindful attention to the most important matters. Attention must also be placed on the documentation requirements for Country-by-Country reporting.

From a tax administration perspective, effective identification and assessment of transfer pricing documentation is an essential component in the early stages of a transfer pricing risk assessment. In addition, it helps support selecting transfer pricing cases to take forward to an audit. This is important given the limited resources of tax administration in order to be targeted.

Candidates should reference the OECD Transfer Pricing Guidelines (2017), Chapter IV: Administrative Approaches to avoiding and resolving transfer pricing disputes.

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”.

Simultaneous tax examinations are conducted separately within the framework of national law. That is, each tax administration audits the activities of an MNE group's relevant entities within its jurisdiction pursuant to the application of its local law. However, in concert with the separate audit activities, the tax administrations will exchange relevant information gained in the individual audits, with the goal of agreeing on a consistent set of facts. Conversely, a joint audit is a coordinated effort by tax authorities to not only reach consensus on the facts of the case, but also to reach an agreement on the tax treatment of the audited transaction.

In a simultaneous control, two or more Member States agree to conduct a simultaneous control in their own territory, of one or more persons of common or complementary interest to them, with a view to exchanging the information thus obtained. The facts might be summarised in a final report, which is not binding for the participant tax administrations.

A joint audit can be understood as a step further where tax authorities will form a joint audit team that executes the agreed audit programme jointly in all involved countries and also reaches a joint binding conclusion.

Multilateral audits encompass various tax jurisdictions whereby the tax administrations will each examine MNEs from a transfer pricing risk perspective.

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 more timely 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 requires 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 through 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.

Question 7

Candidates could note that financial transactions between associated entities within an MNE should have regard to the arm's length principle and identify the commercial and financial relations (refer to guidance at Chapter I, D.1 of the OECD TPG). Emphasis is placed on the accurate delineation of the transaction as a framework for assessing the arm's length nature of intra-group financial transactions. This includes an examination of each financial transaction in terms of the functions, assets, and risks of each associated enterprise involved in the transaction.

Reference is made to the OECD's Transfer Pricing Guidance on Financial Transactions (Inclusive Framework on BEPS: Actions 4, 8-10.

Some key transfer pricing risks in relation to financial transactions include:

- Intra-group loans (lender and borrowers perspective, credit ratings, group membership, covenants, guarantees, fees and charges, cost of funds – arm's length interest rate, arm's length conditions);
- Cash pooling (arm's length price);
- Hedging (examination of risks);
- Financial guarantees (economic benefits, group membership, financial capacity of guarantor, arm's length price);
- Captive insurance (assumption of risk, arm's length price); and
- Risk-free and risk-adjusted rates of return.

Consideration has to be given to the commercial reality and economically relevant characteristics of actual financial transactions.

Thin capitalisation rules and interaction with transfer pricing may be raised by candidates.

A company is typically financed (or capitalized) through a mixture of debt and equity. Thin capitalisation refers to the situation in which a company is financed through a relatively high level of debt compared to equity. Thinly capitalised companies are sometimes referred to as highly leveraged or highly geared.

The amount of interest that a company pays is determined by two factors: a) The rate of interest (or similar condition) applied to its loans. b) The amount of those loans. Transfer pricing rules unequivocally apply to the rate of interest (or similar condition) applied to its loans. The rate of interest is the price that is paid on a loan, and transfer pricing rules require that such a price conform to the arm's length principle.

Candidates can use relevant case law to support their conclusions.

A summary of one relevant case is : Chevron Australia Holdings Pty Ltd [2017 FCAFC 62].
The underlying issue in the Chevron case is how one should construct the hypothetical transaction between independent parties for the purposes of applying the transfer pricing provisions. The potential tax adjustments that may arise under the transfer pricing provisions will be affected by the features that are to be taken into account in constructing the hypothetical. In the Chevron case, one of the key issues was whether the features of the hypothetical transaction should include the provision of security or other covenants in favour of the lender.

As is clear from the decision of Justice Robertson, where the hypothetical loan between an independent borrower and lender is to include security provided in favour of the lender to secure repayment of the loan, then the inclusion of this feature can affect the conclusion as to the arm's length interest rate for the purposes of applying the transfer pricing rules.

The question at issue was whether the consideration actually provided by CAHPL (i.e. the interest rate and nothing else) exceeded the arm's length consideration for that property. This task required one to assess what the consideration would be under a hypothetical transaction between independent parties dealing at arm's length.

The evidence found was that the borrowing by CAHPL would not have been sustainable if obtained from an independent party. As a standalone company, severed from the financial strength of its ultimate parent and corporate group, CAHPL could not secure a loan for an amount equivalent to $US2.5 billion at the rate obtained by its subsidiary with the backing of the ultimate parent.

The implications of this decision include:

- The Full Federal Court has now made it very clear that an Australian subsidiary of a multinational group is not to be treated as if it were an 'orphan' when undertaking transfer pricing arm's length calculations. In fact, some level of parental support may need to be assumed to exist depending on the facts/situation.

- If a borrower is part of a group that has a policy to borrow externally at the lowest cost and that has a policy that the parent will generally provide a third party guarantee for a subsidiary that is borrowing externally, then in the case of related party debt, the interest rate payable by an Australian subsidiary should probably be set at a level that assumes a parent company guarantee has been given.

- As a result, the appropriate interest rate on internal debt will likely be closer to the parent's global cost of funds for the relevant currency.

- It remains to be seen whether pretending that the debt was raised with the benefit of a guarantee given by the parent carries the further implication that the borrower can also pretend it paid a fee for the benefit of that fictitious guarantee.

Question 8

Part 1

Candidates may respond with a range of responses depending on their understanding of BEPS and the Two Pillar solution.

The term 'base erosion and profit shifting, or BEPS initiated following the 2008 global financial crisis and the G20 commitment to prioritise tax. At the time there was a focus to protect tax bases in order to repair government budgets.

The Two Pillar solution largely arises from the OECD's BEPS Action 1 Report which noted that the digitalisation of the economy created gaps in the tax base that could not be fixed with the current international tax framework which allocated taxing rights on the basis of physical presence. This focused on key principles of residence, source and the transfer pricing concept of arm's length. As the economy has evolved to create new business models and tax competition has become a driver for multinational groups to adapt tax strutting techniques, countries have found it challenging to align their tax systems and fiscal policy with the political consensus that multinationals pay their "fair share" of tax.

The Two Pillar solution is the response from 137 countries to develop a new framework to implement from 2023. However, the European Commission has recently drafted a tax directive which is intended to take effect by 31 December 2023, instead of the original 1 January 2023 date. A number of key countries have not announced dates for implementation, which creates some uncertainty for multinational groups, advisors and tax administrations.

Pillar One and Two differ significantly from a policy perspective.

Pillar One – Amount A is to apply to the largest and most profitable companies with global turnover or sales of more than 20 billion Euro and a profit margin of more than 10%. However, extractives and regulated financial services are excluded from scope. Subject to successful implementation, the proposal is to reduce the global turnover to 10 billion after seven years. Approximately 100 groups are expected to be within scope of Pillar One. Amount A allocates taxing rights over 25% of the residual profit (i.e. profits more than 10%) to the jurisdictions where the customers and users of those multinational groups are location (market jurisdictions). Revenue sourcing rules apply which are unique to Amount A. In order for a jurisdiction to be allocated taxing rights where the multinational group derives a minimum of 1 million Euro in the jurisdiction or 250,000 Euro for smaller jurisdictions. If a jurisdiction adopts Pillar One, they have an obligation to remove Digital Services Tax and other relevant, similar measures and not adopt them in the future.

Where the residual profits of an in-scope multinational group are already taxed in a market jurisdiction, a marketing and distribution profits safe harbour will cap the residual profits allocated to the market jurisdiction through Amount A. This may result in a jurisdiction not receiving an Amount A allocation.

Amount A will also provide tax certainty for multinational groups and tax administrations by providing mandatory and binding dispute resolution, with an elective regime for low-capacity countries. Amount A is intended to be made effective by way of a Multilateral Convention (MLC) and will apply separate to any existing treaty.

Amount B of Pillar One will establish a simplified and streamlined approach to the application of the arm's length principle, with a focus on the needs of low capacity countries. Amount B is to apply to in-country baseline marketing and distribution activities. One of the key reasons for Amount B is that some low capacity countries do not have the expertise and resources to undertake complex transfer pricing analysis and also from a practical perspective have challenges identifying comparable companies in their countries. Amount B will potentially apply to a larger number of multinational groups, but its scope will be limited to more routine functions. Although limited detail has been publicly released, it is expected that Amount B will result in simplification and certainty for both multinationals and tax administrations alike by providing for a fixed return for the activities. For example, a functional analysis and comparability analysis is unlikely to be required if the multinational group undertakes baseline marketing and distribution activities.

The OECD has released consultation on a number of Pillar One building blocks, including scope exclusion (extractives and regulated financial services), revenue sourcing, tax base and other topics. However, much of the key detail has not been publicly released by the OECD with technical work continuing. If Pillar One is adopted by a jurisdiction, it must be adopted in its entirety with consistency and certainty being a key element

Pillar Two is more progressed than Pillar One with Model Rules being released by the OECD in December 2021 and detailed commentary in March 2022. Pillar Two is a new taxing right, designed to apply a minimal tax on global profits on multinational groups with consolidated annual revenue of 750 million Euro or more (broadly aligned with CbCR requirements).

The key parts of Pillar Two are:

- The Global anti-Base Erosion (GloBE rules), comprising the Income Inclusion Rule (IIR) and the Undertaxed Payments (or Profits) Rule (UTPR) which imposes a 15% global minimum tax; and

- The Subject to Tax Rule (STTR), comprising a treaty-based rule that allows source countries to impose a minimum 9% tax on certain gross payments made to related parties or associates. The STTR takes precedence to and is creditable under the GloBE rules.

There are minimal exceptions to Pillar Two, with the main one being international shipping income.

Pillar Two is determined according to consolidated financial accounts with certain adjustments on a country-by-country basis. It combines tax and accounting concepts to create a new taxing right. Countries have the ability to adapt the elements through domestic legislation or regulations in accordance with the OECD's common approach. The OECD has undertaken public consultation on Pillar Two in relation to the implementation framework. The Pillar Two rules are complex and will require a complex understanding of financial accounting.

Pillar Two has less direct links with transfer pricing concepts. However, it is expected that some multinational groups may undertake business restructures to avoid booking revenue in jurisdictions which do not adopt Pillar Two. Further, countries which currently impose a corporate tax rate of less than 15% are expect to increase the tax rate, as has already been announced by some countries.

The successful implementation of the Two Pillar solution would mark a fundamental change to the international tax framework. It would likely be seen as assisting in the global fight against tax avoidance. Although there is limited detail on the revenue impact for individual countries, the OECD has estimated that additional revenue will be raised globally.

<u>Part 2</u>

Chapter VII of the OECD Transfer Pricing Guidelines provides guidance on Intra-Group Services. The key issues are whether services have been provided by one member of a group to other members, and if so, to establish an arm's length price.

In some instances, a group will provide a range of services to its members including administration, technical, financial and commercial. The group should ensure that services are appropriately identified and associated costs are allocated with the group in accordance with the arm's length principle.

In accordance with B.1, it should be determined whether intra-group services have been rendered.

Key points include:

- Shareholder activities would not usually be considered an inter-group service (refer to paragraph 8.10 for examples).
- Duplicate services should not usually be charged.
- Incidental benefits would not usually be paid for by independent enterprises.
- Centralised services are usually considered a to be an intra-group service.
- In a transfer pricing context, consider whether independent enterprises would likely charge for the service.

Once it is determined that an inter-group service has been rendered, there is a need to determine if the amount of the charge is in accordance with the arm's length principle. The different options are direct charge methods and indirect charge methods (refer to B2.2.1 and B2.2.2).

In relation to low value-adding services, it is possible to apply a simplified approach (set out in D.1). Paragraph 7.45 includes details of low value-services with paragraphs 7.47-7.49 indicating activities which would not qualify for the simplified approach.

D.2. Sets out the simplified approach for law-value adding intra-group services including application of the benefits test, determination of cost pools and allocation.

Question 9

Part 1

The options available to the multinational will likely depend on domestic laws and regulations in the countries the audit adjustments relate to. However, the following options are likely to be available:

- Pay the assessments and not take any action;
- Object or appeal against the assessments;
- Undertake litigation in the country which the made the adjustment; or
- Apply for Mutual Agreement Procedure (MAP) assistance.

Options 2 and 3 have not been addressed as these will vary depending on the legislation and administrative procedures of the tax administration. However, the procedure for MAP is mostly uniform and is addressed in tax treaties. Although tax treaties may vary depending on the country, the 2017 OECD Model Tax Convention on Income and Capital is referenced.

Article 26 addresses MAP and regardless of the domestic remedies available under domestic law, the taxpayer may present their case to the tax administration (competent authority) which the audit adjustments relate to. However, this must be submitted within a 3 year timeframe. The competent authorities of the respective states, who are employees of the tax administration will seek to eliminate double taxation (i.e. one tax administration may grant relief). If the case is not resolved within two years, the taxpayer has the option to request that the issue/s be resolved under arbitration (as long as the issue has not previously been considered by a court or tribunal).

However, the countries which the audit adjustment relates to must have entered into a treaty. If they have not, MAP is not available to the multinational.

Part 2

The multinational has a number of options which candidates could recommend. The most obvious ones are set out below.

The multinational may request an Advance Pricing Arrangement (APA). An APA is covered in Chapter IV (F) of the OECD Guidelines. An APA is an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria for the determination of the transfer pricing for those transactions over a fixed period of year. As intellectual property is a complex area of transfer pricing, it would be recommended that the multinational consider entering into a bilateral APA with the tax administrations. However, due to the resources required, time consuming examination process and potential costs, it is suggested that this is limited to the countries with the most material transactions. The tax administrations must also offer an APA and there must be treaties between the countries for a bilateral APA.

Paragraph 4.156 highlights one of the key benefits of a bilateral APA is the reduction or elimination of the possibly of double taxation, which has arisen in the audit.

Another possible suggestion is for the multinational to improve the quality of their contemporaneous transfer pricing documentation in order to comply with the arm’s length principle. A key element is updating their transfer pricing analysis, which includes functional analysis, transfer pricing methodology and comparability. This documentation should be updated on a yearly basis to consider any changes in transactions, the business operations of the multinational and update comparables. Chapter V of the OECD Guidelines covers documentation, including country-by-country documentation. This information would potentially be of a benefit to tax administrations if they were to undertake a transfer pricing review or examination in the future.