THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

December 2022

MODULE 3.03 – TRANSFER PRICING OPTION

SUGGESTED SOLUTIONS

PART A

Question 1

Part 1

Candidates are expected to accurately delineate of the associated enterprises of the Stolhurst Group (international related party dealings).

Related party sales:

- Stolhurst Parentco (Country G) sells physical products (finished goods and replacement parts) to Stolhurst Sub 1 (Country H)
- Stolhurst Parentco (Country G) sells physical products (finished goods and replacement parts) to Stolhurst Sub 2 (Country I)

Related party purchases:

- Stolhurst Sub 1 (Country H) purchases physical products (finished goods and replacement parts) from Stolhurst Parentco (Country G)
- Stolhurst Sub 2 (Country I) purchases physical products (finished goods and replacement parts) from Stolhurst Parentco (Country G)

Research and development / Intellectual Property:

- Stolhurst Sub 1 (Country H) pays royalties to Stolhurst Parentco (Country G) for the use of intellectual property (brand name).
- Stolhurst Sub 2 (Country I) pays royalties to Stolhurst Parentco (Country G) for the use of intellectual property (brand name).
- Stolhurst Parentco (Country G) receives royalties from Stolhurst Sub 1 (Country H) for the use of intellectual property (brand name).
- Stolhurst Parentco (Country G) receives royalties from Stolhurst Sub 2 (Country I) for the use of intellectual property (brand name).

Related party financing:

- Stolhurst Sub 3 (Country J) provides a loan to Stolhurst Parentco (Country G) and receives interest.
- Stolhurst Parentco (Country G) receives a loan from Stolhurst Sub 3 (Country J) and pays interest.
- Cash pooling arrangement between Stolhurst Parentco (Country G) and Stolhurst Sub 3 (Country J).

Related party services:

- Stolhurst Sub 4 (Country K) provides administrative support and marketing services to Stolhurst Parentco (Country G).
- Stolhurst Parentco (Country G) receives administrative support and marketing services from Stolhurst Sub 4 (Country K).

Part 2

Candidates should note 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. Further, 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.

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.

Candidates may note the practicalities/qualitative nature of functional interviews to 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.

Associated entity within the MNE group	Functions	Assets	Risks	Characterisation
Stolhurst Parentco (Country G)	Research and development Sales/marketing Distribution Strategy development / strategic decision making Supplier selection	Intellectual property Property, plant and equipment – manufacturing facility Offices Warehouses Staff	Market risk Manufacturing risk Financing risk Credit risk Inventory risk Capital investment risk Warranty risk Obsolesce risk	Fully-fledged manufacturer and Intellectual property owner
Stolhurst Sub 1 (Country H)	Procurement Demand planning Retailing	Warehouse Staff Retail stores	Market risk Warranty risk Obsolesce risk	Distributor and retailer
Stolhurst Sub 2 (Country I)	Procurement Demand planning Retailing	Warehouse Staff Retail stores	Market risk Warranty risk Obsolesce risk	Distributor and retailer

Stolhurst Sub 3 (Country J)	Investment management services / financing	Staff Offices	Market risk Financing risk Credit risk	Investment management company
Stolhurst Sub 4 (Country K)	Administrative and marketing services	Staff Offices	Market risk	Services provider

Question 2

Part 1

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:

Section B: 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 to related party sales and purchases by comparing:

- The prices paid between the sale of finished goods and replacement parts by Stolhurst Parentco (Country G) to Stolhurst Sub 1 (Country H) and the sale of finished goods and replacement parts by Stolhurst Parentco (Country G) to Independent Co 1 (Country Y).
- The prices paid between the sale of finished goods and replacement parts by Stolhurst Parentco (Country G) to Stolhurst Sub 1 (Country H) and the sale of finished goods and replacement parts by Stolhurst Parentco (Country G) to Independent Co 2 (Country Z).
- The prices paid between the sale of finished goods and replacement parts by Stolhurst Parentco (Country G) to Stolhurst Sub 2 (Country I) and the sale of finished goods and replacement parts by Stolhurst Parentco (Country G) to Independent Co 1 (Country Y).
- The prices paid between the sale of finished goods and replacement parts by Stolhurst Parentco (Country G) to Stolhurst Sub 2 (Country I) and the sale of finished goods and replacement parts by Stolhurst Parentco (Country G) to Independent Co 2 (Country Z).
- The prices paid between the sale of finished goods and replacement parts by Stolhurst Parentco (Country G) to Stolhurst Sub 1 (Country H) and the sale of finished goods and replacement parts by Stolhurst Parentco (Country G) to Stolhurst Sub 2 (Country I).

A CUP method could potentially be applied to the royalty transactions by comparing:

- The royalty between Stolhurst Parentco (Country G) and Stolhurst Sub 1 (Country H) and the royalty between Stolhurst Parentco (Country G) and Independent Co 1 (Country Y).
- The royalty between Stolhurst Parentco (Country G) to Stolhurst Sub 1 (Country H) and the royalty between Stolhurst Parentco (Country G) and Independent Co 2 (Country Z).
- The royalty between Stolhurst Parentco (Country G) and Stolhurst Sub 2 (Country I) and the royalty between Stolhurst Parentco (Country G) and Independent Co 1 (Country Y).
- The royalty between Stolhurst Parentco (Country G) to Stolhurst Sub 2 (Country I) and the royalty between Stolhurst Parentco (Country G) and Independent Co 2 (Country Z).

- The royalty between Stolhurst Parentco (Country G) and Stolhurst Sub 1 (Country H) and the royalty between Stolhurst Parentco (Country G) and Stolhurst Sub 2 (Country I).

There maybe a potential CUP for the cash pooling arrangement.

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

- Contractual terms.
- Functions, assets and risks.
- Characteristics of property or services.
- Economic circumstances.
- Business strategies.

Regard needs to be given to all of the comparability factors in applying a CUP analysis.

Section C: 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 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).

Again, 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).

Whilst the resale price method may be considered, it is likely that it would not be applied in this situation given that the resellers of the product (Stolhurst Sub 1 and Stolhurst Sub 2) that purchase from Stolhurst Parentco add value to the sale process via a retailing function.

Section D: Cost plus method:

- 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.

Administrative support and marketing services

A cost plus may be applied to the management fee paid to Stolhurst Sub 4 by Stolhurst Parentco, Stolhurst Sub 1 and Stolhurst Sub 2. The margin applied would need to give consideration to the value of the services provided.

Consideration would need to be given to Chapter VII: Special Considerations for Intra-Group Services (OECD TP Guidelines, 2007). i.e. 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.

Part III: Transactional profit methods

Section B: Transactional net margin method (TNMM):

- 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 each entity within the Stolhurst group. 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). An appropriate PLI may then be applied, e.g. EBIT/Sales (profitability) with distribution/marketing/sales functions. The net profits noted for Stolhurst Sub 1 and Stolhurst Sub 2 are very low relative to their functions, assets and risks, pending a benchmarking exercise.

Section C: Transactional profit split method:

- 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 would most likely not be applied in this situation given the associated enterprises do not appear to be contributing towards the development of intellectual property. The research and development function are conducted by Stolhurst Parentco and the intangible property is legally owned by Stolhurst Parentco also.

Part 2

The level of transfer pricing risk that may exist for the Stolhurst Group would need to be examined carefully given the breadth and potential materiality of the international related party dealings between associated entities.

A transfer pricing advisor would develop a risk framework and recommendations following a full functional analysis, including functional interviews across the entities within the group.

Transfer pricing documentation would assist in demonstrating that the related party arrangements within the Stolhurst group align with the arm's length principle.

Some key risks that would need to be raised include:

- The arm's length nature of the sales and purchases between associated entities.
- The arm's length nature of the royalties paid/received between associated entities.
- The arm's length nature of the management fees paid/received between associated entities.
- The arm's length nature of the cash pooling arrangement between associated entities.
- Are there inter-company agreements that exist in relation to all of the above transactions?
- Does the substance of the arrangements match the form?
- The intellectual property legally owned by Stolhurst Parentco:
    - Is the legal ownership actually with this entity?
    - What is the extent and nature of the research and development conducted?
    - Do any other associated entities contribute towards the 'DEMPE' functions of the IP? Ownership of intangibles and transaction involving the development, enhancement, maintenance, protection and exploitation of intangibles.
    - Has there been any transfer of IP?
- The low tax rates of some of the associated entities within the group creates an opportunity for tax arbitrage. Would need to understand the rationale for the operations of the entities within the group and their interaction.
- The difference in royalty rates charged between different entities within the group and independent entities.
- Has any business restructuring occurred? If so, a pre and post FAR would be required and a full analysis of the commercial reality of the restructure.
- If any restructuring has occurred, particularly in relation to the IP, implications in relation to the OECD BEPS Project, Actions 8 – 10 (Aligning Transfer Pricing Outcomes with Value Creation) may include:
    - Arm's-length pricing should be based on accurately delineated transactions.
    - Analysis of the contractual relations together with evidence of the actual conduct of the parties, including control over risks.
    - Where economically relevant characteristics of a transaction are inconsistent with contractual terms, the actual transactions should in general be identified based on the actual conduct of the parties
    - The legal form of the transaction relative to the economic reality of the transaction.
    - Has there been an AL compensation for any potential transfer of assets?

PART B

Question 3

Part 1

In undertaking a functional analysis of Charlie Corp, reference is made to the OECD Transfer Pricing Guidelines 2017, Chapter I, D.1.2. The functional analysis (FAR) should identify the economically significant activities and responsibilities undertaken, assets used or contributed and risk assumed by the parties to the transactions.

Candidates may take different approaches to responding to this question such as setting out the FAR prior to and after the business restructure or alternatively, they may summarise the changes post restructure.

Pre-business restructure

Parent Co:

- Undertakes Research & Development
- Owns Intellectual Property (trade names, patents, technical know-how and designs)
- Fully fledged manufacturer
- Full risk bearing

For transfer pricing purposes, Parent may be classified as an entrepreneur, undertaking fully fledged manufacturing with ownership of intellectual property.

Subsidiary:

- Did not exist

As Charlie Corp prior to the business restructure did not have any cross board associates, no transfer pricing documentation, including functional analysis would be required to be prepared. Candidates should reference the OECD Transfer Pricing Guidelines (2017), Chapter IX - Transfer Pricing Aspects of Business Restructures. Specifically, Part I, Arm's length compensation for the restructuring itself and Part II, Remuneration post-restructuring controlled transactions.

Parent Co:

- Purportedly undertakes functions as service provider for Sub B including:
- Research and development
- Managerial, administrative and technical services
- Assets include office building, computers, office equipment
- Limited risk (as compensated as service provider)

Classified as a service provider for Sub B, an associated enterprise.

Sub B:

- Legal ownership of IP (trade names, patents, technical know-how and designs)
- Manufacturing of product
- Undertakes logistics, procurement and distribution
- Plant and equipment, buildings
- Assumes all risk (according to legal documentation)

A newly established entity, Sub B has been established in Country B. Charlie Corp has undertaken a business restructure whereby material assets (valuable IP, manufacturing etc) have transferred from Parent Co to Sub B. Further, Parent Co has discontinued to own IP and

undertake manufacturing and distribution activity for the Group. According to the facts provided, the only function undertaken by Parent Co is as a service provider solely for Sub B. Sub B purportedly undertakes key activities and bares all of the risk for Charlie group as the entrepreneur associated with owning the IP, undertaking manufacturing activity and distribution functions.

Part 2

TP risks which the tax administration of Country B may identify, along with follow up questions for Charlie Corp include:

- What is the commercial and economic rationale for entering into the business restructure by both Parent Co and Sub B having regard to the arm's length principle?

- What other options were realistically available for both Parent Co and Sub B regarding the restructure?

- Has there been an arm's length compensation for the transfer of assets and risk from Parent Co to Sub B?

- Was a valuation prepared to an arm's length amount of compensation for the transfer of the intellectual property

- Should Sub B compensate Parent Co for loss of profit making potential, discontinuing key functions and incurring substantial losses (from discontinuing manufacturing, redundancy of staff and having to dispose of plant and equipment/buildings)?

- Has contemporaneous documentation been prepared that demonstrates the decision making process of the business restructure and a full functional analysis (including consequence of the profit potential being shifted from Parent to Sub B)

- Regarding the functions undertaken by Parent Co for the benefit of Sub B, is the cost plus 7.5% an arm's length compensation for contract R&D, managerial, administrative and technical services?

- BEPS Actions 8-10, Aligning Transfer Pricing Outcomes with Value Creation (e.g. refer to annex to Chapter VI to the TPG covering hard to value intangibles) potential considerations include:

    - Parent Co still continues to undertake key functions/activities including research and development relating to IP and employee key technical and decision making staff.

    - Arm's length price/compensation should be based on accurately delineated transactions.

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

    - Consideration should be given to whether economically relevant characteristics of a transaction are inconsistent with contractual terms, the actual transactions should be identified based on the actual conduct of the parties (i.e. if Parent Co continues to make key decisions and economically undertake key functions/activities for Charlie Corp).

    - The legal form of the transaction relative to the economically reality of the transaction/s.

    - Ownership of intangibles and transactions involving the development, enhancement, maintenance, protection and exploitation (DEMPE) of intangibles

(i.e. does Parent Co economically own IP, is Sub B instructing Parent Co re R&D or simply funding the cost with key decisions made by Parent Co?)

Some candidates will note the tax arbitrage between Country B (15%) and Country A (30%) with the possibility that the restructure is likely to be driven based on tax savings.

Question 4

Part 1

Candidates should refer to the OECD Model Tax Convention on Income and Capital (OECD MTC) or the United Nationals Double Taxation Convention (UNDTC).

Article 5 of the OECD MTC defines a permanent establishment (PE) as including:

- a place of management,
- a branch,
- an office,
- a factory,
- a workshop, and
- a mine, oil or gas well, a quarry or any other place of extraction of natural resources.

A building site or construction or installation project constitutes a PE only if it lasts more than twelve months according to paragraph 3.

Paragraph 4 lists the exclusions to an existence of a PE, none of which would likely apply based on the facts provided.

Regard should be had to the Double Tax Agreement between Megalop and Gigalot, but as this is not available to candidates, the response should be based on the OECD MTC or UNDTC .

Based on the facts provided, it is highly likely that Flexible Group will have a PE in Gigalot due to executing a three year contract for the design, engineering and construction of a new airport runway in the jurisdiction. Another contributing factor is the company will have an ongoing physical presence with the building on site to oversee the construction work for the duration of the three year contract.

Better candidates may reference the OECD MTC Commentary to Article 5 (page 116). For example, paragraph 10 confirms that the “place of business” covers any premises, facilities or installations used for the carrying on of the business. Paragraphs 49-57 of the Commentary to Article 5 are likely to provide guidance based on the facts provided as a PE is likely to due satisfying a building site or construction or installation project.

Part 2

Article 7 - Business Profits of the OECD TPG applies to the attribution of potential profits to a PE.

Some candidates may reference the BEPS Action 7 Final Report which includes examples in the report governed by the authorised OECD approach (AOA) contained in the 2010 version of Article 7. The March 2018 Report did mandate the development of additional guidance on how the existing rules of Article 7 would apply to PE’s resulting from the changes in the Report (in particular for PEs outside the financial sector), taking into account the revised guidance contained in the Report on Aligning Transfer Pricing Outcomes with Value Creation (Actions 8-10 Report, OECD 2015).

Guidance includes examples dealing with the attribution of profits to PE in a range of scenarios. After it has been established that a PE exists (and it has been confirmed that there are no exceptions that apply such as the PE being preparatory or auxiliary in nature), the attribution of profits to the PE should be determined under an analysis of the amounts of revenue and expense that the PE would have recognised if it were a separate and independent enterprise.

PART C

Question 5

Part 1

Reference is made to the OECD Transfer Pricing Guidelines; Chapter IV, E – Safe Harbours.

The Island Group, by adhering to safe harbours, provides itself a number of benefits including:

- Transactions can be filed with greater certainty;
- A lower cost of compliance given a lower risk of review or audit by tax administrations;
- Contribute towards a robust tax risk management framework;
- Developing a more collaborative relationship with tax administrations;
- Reduce the tax risk profile of the group;
- Provides a more optimal use of resources; and
- Reduce administrative burdens.

Part 2

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

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

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

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

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

- Reduction in the risk of double taxation;

- Ease of annual review of the transfer pricing documentation;

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

Part 3

Reference is made to the OECD Transfer Pricing Guidelines (2017) at section B – Statement of the arm's length principle (ALP). Section B.1 has regard to Article 9 of the OECD Model Tax Convention as the authoritative statement of the ALP.

ALP has been adopted by OECD member countries and other countries mainly as it provides broad parity of tax treatment for members of MNE groups and independent enterprises, putting associated and independent enterprises on a more equal tax footing, and avoiding the creation

of tax advantages or disadvantages as well as removing tax considerations from economic decisions; this promotes growth in international trade and investment.

Paragraph 1.9 – ALP works effectively in a vast majority of cases – examples are provided and reference is made in relation to dealing with more difficult cases including the use of transactional profit split method in Chapter II, Part III. Paragraph 1.13 highlights the difficulty from a tax administration and taxpayer perspective in documenting the ALP but also notes the importance of finding a reasonable estimate of an arm's length outcome based on reliable information using judgement.

Reference is made to section B.2 – Maintaining ALP as the international consensus. Paragraph 1.14 states that the view of OECD member countries continues to be that ALP should govern the evaluation of transfer prices among associated enterprises. Further, ALP is sound in theory since it provides the closest approximation of the working of the open market having regard to the economic realities of the taxpayer's particular facts and circumstances.

Paragraph 1.15 notes that an absence of the use of ALP would substantially increase the risk of double taxation. In addition, no legitimate or realistic alternative to ALP has emerged.

Question 6

Part 1

Tax certainty is usually a very important issue for multinationals enterprises (MNEs) and tax administrations. International tax co-operation assists to avoiding double taxation and the uncertainty arising from an MNEs interaction with different tax systems. Tax certainty promotes investment, jobs and growth and is an integral part of the tax system.

Double taxation arises when the same taxpayer is taxed twice on the same income by more than one jurisdiction or if more than one taxpayer is taxed on the same item. In the context of MNEs, there is an increased risk of double taxation due to them usually undertaking business operations in multiple countries. It may arise if an MNE undertakes cross border transactions with associated enterprises.

An MNE will not be able to request Mutual Agreement Procedure (Article 25 of OECD Model Tax Convention) where a taxpayer considers the action of one or both countries has resulted or will result in taxation not in accordance with the Treaty or Double Tax Convention. MAP is a mechanism for eliminating double taxation because of a transfer pricing adjustment for example by a tax administration following an audit or examination. The MAP article enables Competent Authorities from governments of the relevant countries to consult with the intention of resolving international tax disputes such as transfer pricing.

Where there is no treaty with the other country, the MNE would only be able to rely on domestic remedies such as objection or appeal if they considered the tax administration undertook compliance activity which resulted in double taxation.

In relation to tax certainty, the MNE would not have the option of a bilateral or multilateral Advance Pricing Arrangement (APA). 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 time. The MNE would only be able to request a unilateral APA, which is solely between an MNE and a tax administration (i.e. more limited application)

Part 2

If a country/jurisdiction does not have an extensive tax treaty network, this will limit their ability to receive Country by Country information (CbC), which came about as a result of Base Erosion and Profit Shifting (BEPS) Action 13. To receive and exchange information between jurisdictions, the country must have executed the CbC reporting Multilateral Competent Authority Agreement (MCAA), EU Council Directive, be a signatory to bilateral Competent Authority Agreement for exchange under Double Tax Conventions or Tax Information Exchange Agreements to facilitate the exchange of CbC reports between tax authorities in different jurisdictions.

Usually the MNE lodges the CbC with their global parent entity. However, if the global parent country hasn't implemented CbC, there is an obligation for the MNE to file the CbC report in another jurisdiction that does exchange - sometimes call 'surrogate parent filing'.

If the country is not a signatory to one of the mechanisms to exchange CbC, they will not receive CbC from another tax administration. However, it may be possible that the country implements domestic legislation requiring the MNE to lodge CbC directly with them. This may limit the ability of the tax administration to undertake transfer pricing risk assessment.

If an MNE is not required to prepare and lodge CbC documentation, this would likely reduce compliance costs and not require them to implement changes or updates to their systems to capture the information for inclusion in CbC.

However, the MNE would still likely have an obligation to lodge the CbC documentation with another jurisdictions' tax administration who would share with other countries in which the MNE has constituent entities or subsidiaries.

Some candidates may provide background information on CbC including referencing the key elements including Master File, Local File and CbC report. These reporting statements include disclosures on:

- the revenues, profits and taxes paid by the global group, broken down by tax jurisdiction;
- the operations and activities of the global group to which an entity belongs; and
- an entities international related party dealings.

Question 7

Part 1

Better candidates would likely provide background regarding Pillar One and Two.

The Two Pillar solution to address the tax challenges of the digitalisation of the economy can be traced back to the OECD's BEPS Action 1 Report.

Pillar One is about reallocating profits of in scope MNEs from one jurisdiction to another. It is based on the conclusion that the existing tax system which allocates taxing rights based on where a MNE is either resident or has a physical presence does not appropriately reflect the ability for MNEs to make substantial profits from a market without having staff or a substantial physical presence.

Pillar One - Amount A is proposed to apply to the largest (approximately 100) and most profitable MNEs with global turnover of more than 20 billion Euro and a profit margin of greater than 10%. Extractive and regulated financial services businesses are excluded from the rules.

Taxing rights over 25% of the residual profit (i.e. profit margin of greater than 10%) is reallocated to the jurisdictions where the customers and users of those MNEs are located (market jurisdictions) with specific revenue sourcing rules for specific categories of transactions.

Tax certainty is a key feature of Pillar One with mandatory and binding dispute resolution (low capacity countries have an elective regime). Pillar One will be made effective by way of a Multilateral Convention, which would apply separate to any existing tax treaty network.

Pillar one requires implementing jurisdictions to remove Digital Services Taxes and other similar measures.

The marketing and distribution safe harbour will "cap" the allocation of Amount A to market jurisdictions that already have taxing rights over a MNEs profits under existing tax rules. Where an MNE qualifies under the safe harbour in the market jurisdictions where it operates, it would need to calculate Amount A, but would otherwise remain subject to the existing rules including on transfer pricing and the elimination of double taxation. This could result in:

- Where the existing marketing and distribution profit is lower than the fixed return, the MNE group will not be eligible for the safe harbour;

- Where the existing marketing and distribution profits exceeds the fixed return, but falls below the safe harbour return, the quantum of Amount A allocated to that jurisdiction would be reduced to the difference between the safe harbour return and the profit already allocated to the local presence; and

- Where existing marketing and distribution profit exceeds the safe harbour return, no Amount A would be allocated to that jurisdiction.

The application of the Amount A safe harbour will likely impact on transfer pricing.

Pillar One – Amount B provides for a fixed return for baseline marketing and distribution activities. This will apply to a broader range of MNEs and will override the existing transfer pricing rules for in scope MNEs.

Amount B aims to standardise the remuneration of related party distributors that perform "baseline marketing and distribution activities" in a manner that is aligned with the transfer pricing arm's length principle.

Amount B is intended to simplify the administration of transfer pricing rules for tax administrations and reduce compliance costs for taxpayers. Amount B would enhance tax certainty and reduce controversy between tax administrations and taxpayers. In these ways,

Amount B has the potential to address certain challenges that tax administrations face in evaluating the arm's length nature of the pricing of distribution arrangements adopted by MNE groups.

It currently assumes that distribution and marketing activities would be identified as in scope based on a narrow scope of baseline activities, set by reference to a defined 'positive list' and 'negative list' of activities that should and should not be performed to be considered as in scope. Quantitative indicators would then be applied to further support and validate the identification of in-scope distributors. Pending further technical work to be performed, it is anticipated that Amount B could be based on a return on sales, together with potentially differentiated fixed returns to account for the different geographic locations and/or industries of the in-scope distributors. Further technical work is also required to both define the precise calculation of the return on sales and the in-scope geographic locations and industries. But given the narrow scope of Amount B, there is currently no provision for Amount B to increase with the functional intensity of the activities of in-scope distributors. Finally, Amount B would not supersede advanced pricing agreements (APAs) or MAP settlements agreed before the implementation of Amount B.

The OECD has recently released an Amount B progress report which indicates that the implementation of Amount B is undecided and subject to further consideration. Under one proposal, the implementation of Amount B would operate under a rebuttable presumption: namely that an entity that acts as a buy/sell distributor and performs the defined baseline marketing and distribution activities qualifying for the Amount B fixed return would render it in scope – but that it will be possible to rebut the application of Amount B by providing evidence that another transfer pricing method would be the most appropriate to use under the ALP. The burden of proof for this will rest with the taxpayer. As the Amount B fixed return will be set by reference to a narrow scope of baseline activities and determined through a benchmarking analysis based on third party comparables, it is intended to approximate results determined under the arm's length principle and hence with existing domestic and treaty law.

Some Inclusive Framework members have expressed an interest to see Amount B first delivered in a pilot programme, which would have the objective of evaluating whether Amount B can meet its aims of simplification and reduced disputes, would allow for monitoring of behavioural change of MNE groups in response to the implementation of Amount B, would allow for phased introduction in Inclusive Framework member jurisdictions and would entail an assessment of the ease of implementation on a phased basis.

The means of implementation of Amount B is subject to further technical work and discussion between the members of the Inclusive Framework.

In summary, Amount A is likely to impact the transfer pricing outcomes of approximately 100 of the largest and most profitable MNEs, but Amount B will have broader application to baseline marketing and distribution activities and is likely to apply to a broader group of MNE's instead of transfer pricing guidelines (it is intended to approximate the arm's length principle) if broadly implemented. There is significant uncertainty over both Amount A and B and the OECD's Inclusive Framework continues to undertake technical work.

The Pillar Two Model Rules (also referred to as "Anti Global Base Erosion" or "GloBE Rules") was released on 20 December 2021 as part of the Two Pillar Solution. The Pillar Two Model Rules are designed to ensure that large MNEs pay a minimum level of tax (15%) on the income arising in each jurisdiction where they operate.

Part 2

Article 5 of the OECD Model Tax Convention should be considered to determine if a Permanent Establishment (PE) or branch exists in relation to cross border transactions.

The concept of a PE or branch determines the right of a tax administration/jurisdiction to tax the profits of an enterprise of another jurisdiction. Under Article 7 - Business Profits of the OECD Model Tax Convention, this cannot happen unless it carries out its business through a PE.

The profits of the enterprise may be taxed, but only the profits attributed to the PE as if it were a distinct and separate enterprise engaged in the same or similar activities. Based on Article 7, the transfer pricing rules will apply irrespective if a transaction involves a company and its branch/PE. Therefore, a PE or branch should be treated as if it were an independent enterprise and the transactions should be remunerated base on the arm's length principle.

Question 8

Part 1

An Advance Pricing Arrangement (APA) is a negotiated agreement between members of an MNE group operating in different countries and one or more revenue authorities. It is designed to provide forward-looking agreement on the way in which transfer prices will be tested between members of the MNE group for an agreed period of time and based on agreed assumptions. APAs can be unilateral (one tax entity and one tax administration, bilateral (2 entities in different countries and 2 tax administrations) and multilateral (several entities and several tax administrations).

Part F of Chapter IV of the OECD Transfer Pricing Guidelines provides guidance on APAs.

Key benefits include:

- Certainty in relation to future years of lodgement.
- Risk mitigation - reduced chance of future client engagement activity by tax administrations regarding transfer pricing.
- Reduce likelihood of double taxation/disputes (BEPS has resulted in tax administrations having more information).
- Time and cost savings in preparing transfer pricing documentation in future years.
- Fostering positive relationships with tax administrations.
- Potential to rollback APA outcome to earlier years.

An APA may be resource intensive, lengthy to negotiate and costly (some tax administrations charge a fee). APAs should only be considered for material transactions between jurisdictions. It is only possible to enter into bilateral and multilateral APAs if the MNE operates in jurisdictions which have tax treaties.

Part 2

Reference is made to the OECD Transfer Pricing Guidelines, Chapter VIII and the interaction with BEPS Action Items 8-10 (Hard to value intangibles).

A Cost Contribution Arrangement (CCA) is defined as a contractual arrangement among MNEs to share the contributions and risks involved in the joint development, production or the obtaining of intangibles, trade assets or services. Such intangibles, tangible assets or services are expected to create benefits for the individual business of each of the participants.

A CCA does not require the participants to combine their operations in order to exploit the outcome from the CCA or to share the profits or revenue. However, participants exploit their interest in the outcomes of the CCA through their individual businesses.

The transfer pricing issues focus on the commercial or financial relations between the CCA participants and their contributions made. Consistent with the arm's length principle, at the time of entering into a CCA, each participant's proportionate share of the overall contribution to a CCA must be consistent with its proportionate share of the overall expected benefits under the arrangement.

Candidates may discuss other aspects of CCA's including research and development, value of participants' contribution, balancing payments, entry, exit and termination.

Question 9

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).

- 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.

Candidates may note a case such as 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.