Answer-to-Question-_1

Part 1)

In carrying out a transfer pricing analysis it is important to accurately delineate the intra-group transactions in order to determine whether an intra-group charge is justified. In doing so, one would need to look into the contractual transactions and the actual transactions that are carried out between associated enterprises.

In this case ATL is the parent entity, ATM is a wholly owned subsidiary of ATL and it is also being assumed that ATDCo 1 and ATDCo2 are also associated enterprises of ATL and ATM.

The intra-group transactions are carried out as per below.

ATL:

- Conducts research and development for the group, creating new products and also improvements in design
- License of design information and intellectual property (know-how) to ATM
- License of intellectual property to ATDCo1
- License of intellectual property to ATDCo2

ATM:

- Manufacturing products for the group
- License of design and know-how from ATL
- Sells finished goods to ATDCo1 and ATDCo2

ATDCo1:

- Purchases finished goods from ATM
- License of IP from ATL

ATDCo 2:

- Purchases finished goods from ATM
- License of IP from ATL

Part 2)

In carrying out a Transfer pricing analysis, one should also carry out a functional analysis in order to determine the functions of the entities, the assets used and the risks involved in the transactions that they carry out. The functional analysis is important in order to choose the relevant transfer pricing methods and in carrying out a comparability analysis.

Company	**Functions**	**Assets**	**Risks**	**Characterisation**
ATL	- R&D for the group - IP Ownership	- Intellectual Property (IP) - Staff	- Risks related to protection of IP - Improving the IP designs - Staff turnover	IP Holding Company
ATM	- Manufacturing products for the group	- Property, plant and equipment for manufacturi	- Operational risks and health and safety in	Limited risk manufacturer

	- Intra-group distributions to ATDCo 1 and ATDCo2 - Use of IP	ng - Inventory of raw materials and finished goods - Staff - Transportation equipment	connection with the manufacturing plant - Inventory obsolescence - Inventory risks - Possibly transportation risks (if transport is carried out by ATM) - Possibly foreign exchange risks	
ATDCo 1	- Distribution of finished products to end customers - Marketing	- Finished goods - Staff - Office - Transportation equipment	- Market risks - Operational risks in relation to marketing - Inventory risks - Transportation risks to distribute goods to end customers - Foreign	Limited risk distributors

			exchange risks	
ATDCo 2	Distribution of finished products to end customers - Marketing	- Finished goods - Staff - Office - Transportation equipment	- Market risks - Operational risks in relation to marketing - Inventory risks - Transportation risks to distribute goods to end customers - Foreign exchange risks	Limited risk distributors

Part 3)

The OECD Transfer pricing guidelines provide that there are 5 transfer pricing methods that may be used in determining the Arm's length price:

- The Comparable Uncontrolled Price Method (CUP)
- The Resale Price method (RPM)
- The Cost-Plus method (CPM)
- Transactional Net Margin Method (TNMM)
- Profit Split method (PSM)

In order to determine the arm's length prices for the intra-group transactions of the ATS group, one should consider the following considerations in applying the transfer pricing methods:

1) CUP method:

- This method compares the **prices** of a controlled transaction with the prices of an uncontrolled transaction. One should take into consideration any internal or external comparables. It is the most direct and reliable method in determining the arm's length price and is the preferred method under the OECD Transfer pricing guidelines. However, it may be difficult to find comparable transactions (both internal and external), especially due to the fact that this method requires both product and functional comparability.

If comparable transactions are found, this method may be used in order to establish the pricing for the following transactions:
- License of intellectual property
- Price of goods purchased by ATDCo1 and ATDCo 2 from ATM.

2) Resale price method:
- This method obtains the arm's length price by deducting the arm's length gross margin from the price at which goods/services are sold to end customers. It is normally used for distribution functions were the distributors do not add significant value. However, it may be difficult to obtain comparables on gross margins applied in comparable transactions and there may also be accounting issues in determining the gross margins.

If comparable gross margins are found, and the CUP method cannot be applied reliably, the RPM may be applied in order to determine the price at which ATDCo 1 and ATDCo 2 purchase finished goods from ATM. This is because the functions performed by ATDCo 1 and ATDCo 2 are simpler than those of ATM.

3) Cost plus method:
- This method adds an arm's length mark-up to the costs incurred in order to determine the price at which a good is sold between associated enterprises. It is important that only direct costs related to the production of the good/service are included.

This method may be applied in determining the charge for R&D carried out by ATL.

Difficulties may arise due to accounting related matters such as which costs are directly related to the production.

4) TNMM:
- This method compares the net margin earned by the associated enterprise to that of an independent enterprise, based on a relevant profit level indicator.

- Given that it uses the net profits, it is less dependent on accounting comparability of the costs and it is also less dependent on product comparability.

This method may be used in determining the prices for ATDCo 1, ATDCo 2 and/or ATM if no reliable comparable information may be found on gross profits in order to apply the RPM.

5) Profit Split Method:

- This method generally splits the profits generated by the relevant associated enterprises based on an estimation of how the profits would have been split between independent parties. It can be done either based on a contribution analysis or a residual analysis. It is generally used when there are highly integrated transactions which are difficult to value separately. This is not the case in this example.

Answer-to-Question-_2__

Part 1) Transfer pricing risks or issues that the tax authority may raise

It is noted that Tuna HeadCo is tax resident in country Yellowfinland, which has a corporate tax rate of 30%. On the other hand, its subsidiaries, Tuna Sub 1, Tuna Sub 2, Tuna Sub 3 and Tuna Sub 4 are tax resident in jurisdictions which have a lower corporate tax rate. As a result, there is a risk that the group would enter into transactions which are not at arm's length in order to shift profits from the high tax jurisdiction to the low tax jurisdictions.

Tuna HeadCo performs R&D services for Tuna Sub 4, which is remunerated at cost plus 5%. The tax administration (Yellowfinland) may be foresee a risk that the remuneration is not at arm's length, particularly considering the value that such IP would have for the group. The tax administration may assess whether the remuneration should be higher.

Furthermore, Tuna HeadCo purchases fish from Tuna Sub 1. Since Tuna Sub 1 is in a low tax jurisdiction, there is a risk that the prices paid by Tuna HeadCo are too high and may not be at arm's length.

Tuna Sub 1 also performs functions in Country V, operating within its territorial waters and the company also has employees and a warehouse in country V. This creates a risk of a permanent establishment in country V and profits may need to be allocated to country V as though the permanent establishment is an independent enterprise transacting at arm's length.

Tuna Sub 2 and Tuna Sub 3 purchase tuna from Tuna HeadCo. Once again, there is a risk that the price is not at arm's length and may be assessed accordingly. The risk would be whether the prices for tuna are too low such that the taxable profits of Yellowfinland are diminished.

Tuna Sub 4 has a preferential tax agreement with country Z whereby it is exempt from corporate tax on the basis of its legal ownership of the IP. Therefore, Yellowfinland may assess whether this agreement would constitute a preferential tax regime or whether this would constitute as state aid. Given that the income of Tuna Sub 4 is exempt, there is a higher risk that the profits are being shifted to Country Z and should this be assessed accordingly.

Part 2)

In order to apply the correct transfer pricing methods, it is important to carry out a comparability analysis. This would determine whether reliable internal or external comparables may be found in order to apply the correct transfer pricing method.

A comparability analysis requires a comparison of the comparability factors:
- Characteristics of the product/service
- Functions performed by the parties, assets used and risks assumed
- The contractual terms of the transaction
- The economic circumstances
- Business strategies

One would need to determine whether the conditions made or imposed in transactions between associated enterprises are comparable to those that are entered into between independent parties.

Depending on the comparability of the transactions, one can determine whether internal or external comparables may be found and apply the correct transfer pricing method.

Should there be any material differences between the transactions that are carried out between associated enterprises and those of independent parties, adjustments may need to be made in order to determine the arm's length price.

A number of issues may arise in finding comparables:
- The transactions carried out by the group may be highly integrated
- It may be difficult to obtain internal or external comparables
- Independent enterprises may enter into transactions based on different terms, making it difficult to perform an adjustment
- The comparables obtained may be in different markets, example foreign markets which have different economic situations
- There may also be timing issues in comparability i.e. the one would need to determine whether the transactions were carried out during the same time; Differences in pricing between the years in which the data was collected and the year in which the transaction is being priced

The above may make a difference in the transfer pricing methodology used. For example, if no reliable comparable information may be found, the group may resort to the Profit Split Method. Nonetheless, it is important that the comparability analysis is clearly documented in the company's transfer pricing documentation. This would justify the use of a specific transfer pricing method and also the reasons for any adjustments made to the comparable information.

Part 3)

Intangible property refers to "something which is not a physical asset or a financial asset which is capable of being owned or controlled for use in commercial activities and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances". Intangible property has become extremely valuable for enterprises. However, it is extremely difficult for experts to value same in the context of transfer pricing. Examples of intangible property include legally protected intangible property, such as patents and trademarks and there are other types of intangible property which is not legally protected, such as customer lists and group synergies.

It may be difficult to price the use or transfer of intangible property as this is generally unique and thus one may not find comparable information. Different payment terms may exist - for example, licensing for the use of IP; contract R&D to develop the IP; cost contribution arrangements where the parties would contribute to the arrangement and also seek to benefit from the use of the IP generated. The contractual terms would influence the transfer pricing method used. In most cases, where the IP is unique, a Profit Split method is used.

In considering the transfer pricing method to be used, reference needs to be made to the DEMPE Functions:
- Development - this refers to the development of the IP, generally conducted through R&D
- Enhancement - ensuring that the IP remains useful and improving same over time
- Maintenance - maintaining the value of the IP
- Protection - legally protecting the IP so that it is not used by independent parties
- Exploitation - using the IP within the group - example through a license

The above functions may be fragmented in the group and thus it may be difficult to price the transactions individually.

Answer-to-Question-_3__

Part 1)

A permanent establishment (PE) is defined in the OECD Model Tax Convention (MTC) and UN Model tax convention as "a fixed place of business through which the business of an enterprise is wholly or partly carried on". After providing for a number of examples, Article 5(3) of the OECD MTC states that "a building site or construction or installation project constitutes a PE if it lasts more than 12 months". Under the UN Model, the duration is shortened to 6 months.

In the case at hand, the Smith Group will be installing technology in Reedland and it is expected that the project will take 6-7 months to complete. Furthermore, the group's employees will be carrying out work in Reedland given that it is a specialised project.

Therefore, in determining whether The Smith Group has a PE in Reedland, reference needs to be made to the double taxation treaty between Albinea and Reedland, in order to determine whether same follows the OECD MTC or the UN Model.

Under the OECD MTC, it would seem that the PE definition is not met as the installation project will last for less than 12 months. However, one would need to consider the facts of the case in due course - and analyse for example any delays in the project. This is especially due to the fact that the Smith Group's employees will be carrying out work in Reedland. Additional consideration would also need to be given to for example, other projects that are carried out by the group in Reedland.

On the other hand, if the treaty is based on the UN model, the installation project would constitute a PE since it is expected to last more than 6 months. As a result, under the UN model, profits would need to be attributed to the PE in Reedland as though the PE was an independent entity transacting at arm's length, and may be taxed in Reedland.

Even though the group sends employees to Reedland on a fly-in fly-out basis, meaning that they will not be spending the entire 6-7 months there; and the group has not established a permanent office in Reedland, given that it is an installation project,it is still determined to be a fixed place of business and thus a PE may still be established under the UN model. In fact, the UN model does favour source taxation in order to help developing countries.

Part 2)

If the Smith Group has a PE in Reedland (as per the UN model), one needs to determine the amount of profits that the PE would generate as if it were operating as an independent enterprise at arm's length. Therefore, EUR 50m profits (assuming that these are the arm's length profits) would be taxable in Reedland. It is pertinent to note that when calculating the profits attributable to the PE, one should consider the OECD Transfer pricing guidelines and apply the transfer pricing rules and methodologies accordingly.

On the other hand, if the double taxation treaty is based on the OECD MTC, one may conclude that there is no PE in Reedland. Therefore, the profits would instead be taxed in Albinea. Nonetheless, if it has seconded workers from a related entity which is incorporated in a different jurisdiction, the transfer pricing rules would still come into play in order to ensure that the consideration paid for the seconded workers is at arm's length. However, this does not seem to be the case as the companies seem to be incorporated in Albinea and tax resident in the same country.

Answer-to-Question-_6__

Part 1)

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

There are essentially two types of cost contribution arrangements; development cost contribution arrangements or services arrangements. A development cost contribution arrangement is generally entered into to develop an asset and expect a future benefit from same. On the other hand, under a service contribution arrangement, one would expect immediate, ongoing benefits from same.

Multinational enterprises generally enter into cost contribution arrangements for developing intangibles. A number of associated enterprises would enter into an agreement to contribute to the development of an intangible, expecting to benefit from the exploitation of the developed intangible in the future. The development of intangibles may involve significant risks and through the cost contribution arrangement, the said risks are spread between the parties to the arrangement as each party would contribute to the arrangement. Furthermore, developing intangibles under a cost contribution arrangement could bring additional benefits as there would be a joint effort among the parties and may bring different expertise to the arrangement.

Services cost contribution arrangements may be entered into in a group where for example the head office provides HR services to a subsidiary and a subsidiary would in turn provide marketing or treasury services to the head office.

It is important that the value of the contributions of each party to the transaction and estimate the benefits that they can use from the arrangement. Any differences should be accounted for through balancing payments accordingly. It is also important that the agreement would note any costs for entry into the arrangement and terminations or withdrawals and how the share of benefits would be apportioned between the parties.

Part 2)

A permanent establishment (PE) is a fixed place of business from which an enterprise which is resident in a state, carries on business in another state. The OECD MTC and UN Model note the following examples of a PE under Article 5:

- a place of management
- a branch
- an office
- a factory
- a workshop
- a mine, oil or gas well, quarry or other place where natural resources may be extracted

There are other cases were a PE may be established, such as a construction or installation project lasting more than 12 months (or 6 months under UN model) or dependent agents who habitually conclude contracts for the enterprise and act exclusively for the enterprise. The UN Model also notes instances were certain services provided in the other contracting state may constitute a PE.

However, where the enterprise would only carry out activities which are of a preparatory or auxiliary nature at that place of business, such as maintaining stock (storage) to transfer to another enterprise, would not constitute a PE. These exceptions are noted in Article 5(4) of the OECD MTC.

Article 7 of the OECD MTC then establishes how business profits are to be allocated to the PE. If the enterprise carries on business in the foreign state through a PE situated therein, the said profits may be taxed in that state. In order to determine the amount of profits which are attributed to the PE, one needs to determine the amount of profits that the PE would make if it were a separate an independent enterprise which is engaged in the same activities. Therefore, one needs to consider the functions of the PE, the assets that would be attributed to it and that it would use in its operations and the risks that it would assume based on the transactions that it carries out. In particular, one should attribute 'free capital' from the enterprise to the PE such that it would be able to carry out the transactions accordingly.

As a result, one would need to determine the profits of the PE as though it were an independent enterprise operating at arm's length. It is imperative that the OECD Transfer Pricing Guidelines are followed accordingly.

Answer-to-Question-_8__

Part 1)

Multinational enterprises carry out a number of intra-group transactions, such as providing intra-group services between the associated enterprises. Intra-group services should be remunerated in accordance with the arm's length principle.

There are a number of issues which need to be considered under the transfer pricing guidelines. Firstly, one needs to determine whether an intra-group service was rendered. This can be determined via the benefits test - a service would have been rendered if the activity provides the company with economic or commercial value and an independent party would have been willing to pay for such service or else the 3rd party would have sourced the service in-house.

The OECD Transfer pricing guidelines provide for a number of activities for which it is determined that a service is not rendered. These include shareholder activities, duplicate activities and incidental services. Shareholder activities refer to those activities that are performed by a parent entity within the group solely because of its ownership interest in the group member, for example, gathering information for the consolidated group accounts. Shareholder activities are not an intra-group service and should be borne and allocated at the level of the shareholder. Furthermore, where a company is simply duplicating a service provided by another company there would be no intra group service provided. An exception may be provided if duplication is temporary or to reduce the risk of a wrong business decision. Incidental benefits refer to those benefits that are incidentally provided to group members through passive association. For example a higher credit rating is provided to a company within the group due to its association with the group. This would not be considered as an intra-group service.

The arm's length charge may be determined via direct or indirect methods. The direct methods would typically charge a company for each service provided. On the other hand, indirect methods pool a number of costs related to the service provided and allocate same to the enterprise receiving the service via an allocation key. The allocation keys could include for example head count, time spent or turnover.

The transfer pricing guidelines also provide for a safe harbour where low-value adding services are provided, whereby the arm's length price is calculated at cost plus 5%. A low value adding service is defined as one which is of a supportive nature; not forming part of the core business of the group; does not require the use of unique intangibles and does not involve a significant assumption of risks. Examples of low value adding services would include HR and accounting. The transfer pricing guidelines specifically note that financial transactions would not be considered as low-value adding services.

Although the above safe harbour would create more certainty and also lower the compliance costs for multinational enterprises, its application would mean that the pricing is not at arm's length.

Part 2)

A safe harbour in transfer pricing is a provision whereby taxpayers would be exempted from applying the transfer pricing rules in specific circumstances or may be applied in a simplified manner. An example of safe harbours in transfer pricing is the low-value adding services explained above.

Safe harbours provide a number of advantages. In particular, they simplify the compliance costs for multinational enterprises in qualifying transactions. This is because the group would not be required to conduct a detailed transfer pricing analysis on those transactions. Furthermore, they also provide certainty to taxpayers in that it is unlikely that the tax authorities would require a transfer pricing adjustment on those transactions and less documentation may be required. Furthermore, tax authorities can re-direct their attention to transactions which are more significant for the group and transactions which are more complex - thus being those transactions were an assessment may be required.

However, safe harbours also bring about a number of concerns. For example, if a safe harbour is only implemented in one country, and not in another the other jurisdiction may disagree with the method employed. This may result in double taxation for the group. Furthermore, it would also lead to transactions not being priced in accordance with the arm's length principle, thus deviating from the foundation of the transfer pricing rules. Safe harbours may also open up opportunities for multinational enterprises to carry out inappropriate tax planning and possibly shift profits from one jurisdiction to the other. Lastly, safe harbours would also raise issues of equity and uniformity as different rules would apply.

Although safe harbours may bring a number of concerns, if implemented correctly, they may bring significant benefits to multinational enterprises and tax authorities who may focus more on the transfer pricing of more value adding activities.