THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

December 2021

MODULE 3.03 – TRANSFER PRICING OPTION

SUGGESTED SOLUTIONS

PART A

Question 1

Part 1

Candidates are expected identify the transactions of the associated enterprises of the GP Group (international related party dealings).

Related party sales:

- GP Sub 1 (Country B) sells physical products to GP Headco (Country A)

Related party purchases:

- GP Headco (Country A) purchases physical products from GP Sub 1 (Country B)

Research and development / Intellectual Property:

- GP Headco (Country A) pays royalties to GP Sub 2 (Country C) for the use of intellectual property

- GP Sub 1 (Country B) pays royalties to GP Sub 2 (Country C) for the use of intellectual property

- GP Sub 2 receives royalties from GP Headco (Country A) for the use of intellectual property

- GP Sub 2 (Country C) receives royalties from GP Sub 1 (Country B) for the use of intellectual property

Related party financing:

- Cash pooling arrangement between GP Headco (Country A), GP Sub 1 (Country B) and GP Sub 2 (Country C)

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 in the MNE group	Functions	Assets	Risks	Characterisation
GP Headco (Country A)	Research and development Sales/marketing Distribution Strategy development Supplier selection Procurement Strategic management and control Financing	Offices Warehouses Staff	Research and development risk Market risk Financing risk Credit risk Inventory risk Capital investment risk Warranty risk	Headquartered company with a research and development, distribution and financing function
GP Sub 1 (Country B)	Inventory management Demand planning Procurement (raw materials) Sales/marketing Procurement Demand planning Financing	Offices Warehouses Staff	Market risk Manufacturing risk Financing risk	Contract manufacturer with a distribution and financing function
GP Sub 2 (Country C)	Potential functions relating to intellectual property (eg. Protection/maintenance) Financing	Offices Warehouses Staff	Market risk Intellectual property risk Financing risk	Intellectual holding company with a financing function

Consideration needs to be given to the terms and conditions in the contracts pertaining to contract manufacturing arrangements between the associated enterprises as well as the economic substance. The functions and risks of the entities may differ as a result particularly noting the management and control of the risks. The supply chain of the GP group would also need to be understood, for example, whether GP Sub 1 warehouses and transfers the physical products manufactured to customers or to GP Headco.

Part 3

Candidates should make reference to the OECD Transfer Pricing Guidelines (2017), Chapter II: Transfer Pricing Methods.

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

Comparable uncontrolled price method

- The CUP method compares the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances.

- Most direct and reliable way to apply the arm's length principle.

- Requires the same or very similar functionality products.

- Useful for commodities and financial transactions.

- An uncontrolled transaction is comparable to controlled transaction for the purposes of a CUP if a) None of the differences (if any) between the transactions being compared or between the enterprises undertaking those transactions could materially affect the price in the open market; or b) reasonably accurate adjustments can be made to eliminate the material effects of such differences. Where is possible to locate comparable uncontrolled transactions, the CUP method is the most direct and reliable way to apply the arm's length principle.

- 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.

A CUP method could potentially be applied:

- Comparing the prices paid between the sale of physical products by GP Sub 1 (Country B) to GP Headco (Country A) and the sale of physical products by GP Sub 1 (Country B) to third-party customers (various markets);

- Comparing the prices paid between the sale of physical products by GP Sub 1 (Country B) to GP Headco (Country A) and the sale of physical products by GP Headco (Country A) to third-party customers (various markets);

- Benchmarking the royalty rate on the royalties paid by GP Sub 1 (Country B) to GP Sub 2 (Country C);

- Benchmarking the royalty rate on the royalties paid by GP Headco (Country A) to GP Sub 2 (Country C);

- Benchmarking the interest rate charged to / received by all associated enterprises party to the cash pooling arrangement (GP Headco, GP Sub 1 and GP Sub 2). The interest rate charged by a third-party financial institution on the loan made to GP Headco could be utilised as part of this application. Purpose/commerciality of the arrangement and benchmarking for what an independent party would charge, having regards to the contractual terms of the arrangement would be required.

Candidates may raise comparability issues with regard to the products sold and different markets (economic conditions). The contractual terms would also need to be examined closely for comparability.

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

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

Regard need to be given to all of the comparability factors in applying a CUP analysis and candidates may explain variations to them.

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).

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

The resale price method could potentially be applied if the final products are being purchased by an associated entity and on-sold to independent parties. This is potentially the case for GP Sub 1 selling final products to an associated enterprise (GP Headco) who is also selling to third parties.

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). When looking at the comparability factors, there may be a comparability issue with regard to the types of products being sold – different quality/grades of commodities being compared, volume traded (adjustment could potentially be made) and different markets (economic conditions). The contractual terms would also need to be examined closely for comparability.

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.

A cost plus could be selected and applied to compensate the contract manufacturing operations in the GP Group. For example, GP Sub 1 could be reimbursed by GP Headco at cost (direct and indirect costs) plus an arm's length mark-up. The arm's length markup could be potentially compared with the mark-up applied to a reimbursement paid by GP Headco to third-party contract manufacturers.

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. A mark-up on the costs of the salaries of the personnel performing the sales/marketing functions may be appropriate.

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 strength in includes that the net profit indicators are less affected by transactional differences than is the case with price, as used by the CUP method. Also, net profit indicators may be more tolerant to some functional differences between the controlled and uncontrolled transactions than gross profit margins.

- As with any one-sided method, it is necessary to examine a financial indicator for only one the associated enterprises (the tested party) which is a benefit when one of the entities to the transaction are complex and has many interrelated activities or lack of information.

- Weaknesses include being influenced by some factors that would either not have an effect, or have a less substantial or direct effect, on price or gross margins between independent parties.

- Also requires information on uncontrolled transactions that may not be available at the time of the controlled transactions as well as may not having enough specific information on profits attributable to controlled transactions including operating expenses.

- Net profit indicators may also be affected by forces operating in the industry.

A TNMM may be applied to the distribution margins of GP Headco and as a secondary profitability test for GP Sub 1. These entities in the GP Group could be the tested parties and compared against companies (applying the comparability analysis framework in Chapter III of the OECD TP Guidelines and the comparability factors). A appropriate PLI may then be applied, e.g. EBIT/Sales (profitability) with distribution/marketing/sales functions. A return on sales (of the commodities) may also be considered.

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.

- Contribution analysis and residual analyses can be conducted.

- A main strength is that it can offer a solution for highly integrated operations for which a one-sided method would not be appropriate.

- Also, when both parties may be found to make valuable contributions to the transaction and therefore a two-sided method is more appropriate. If this is not the case, then it would not be appropriate. Less likely that either party to the controlled transaction will be left with an extreme or improbable profit result.

- A weakness is in the application in terms of accessing information for offshore affiliates and to identify the operating expenses to allocate.

The selection and application of a profit split may be considered in this situation as the associated enterprises own or develop intellectual property (intangibles).

Question 2

Part 1

The tax administration of Country A would review all transfer pricing documentation and facts/evidence gathered as part of the transfer pricing audit.

The facts presented in Question 2 predominately relate to business restructuring events within the GP Group. Therefore, a 'pre and post' analysis utilizing the facts, particularly with regard to the functional analysis would be required. The facts contained within Question 1 would need to be utilized particularly for the 'pre' restructure analysis.

The most significant transfer pricing issue in this case therefore revolves around a business restructure. Candidates would reference and explain the OECD Transfer Pricing Guidelines (2017), Chapter IX: Transfer Pricing Aspects of Business Restructures.

Some key points candidates may raise may include:

- An accurate delineation of the transactions before and after the restructure;
- The business reasons for and expected benefits from the restructuring, including the role of synergies; and
- The other options realistically available to the parties.

Candidates may identify potential transfer pricing risks from the perspective of the tax administration in Country A including:

- What are the contractual terms between the parties (pre and post BR). This would include examining the changes to the contract manufacturing agreements.
- 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? This includes examining the changes to the functions of the entities in the GP Group and the associated changes in risks leading to potential characterisation changes.
- Is the transfer of intellectual property at arm's length from GP Headco to GP Sub 2? What is the commercial rationale for the transfer?
- Valuation issue in relation to the arm's length compensation for transfer of intellectual property.
- Buy-out payments?
- Arm's length nature of the royalties paid associated with intellectual property.
- Loss of profit making potential.
- Commercial and economic rationale for entering into business restructure by all entities having regard to the arm's length principle.
- What options were realistically available for all entities involved in the business restructure?

A full FAR would be required for all entities to establish the global value chain and economic substance of the GP group pre and post restructure.

In addition, stronger candidates may go on to consider the above potential transfer pricing issues/considerations, implications in relation to the OECD Transfer Pricing Guidelines, Chapter VI: Special Considerations for Intangibles, noting some key points:

- 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.
- As part of the business structure and functional analysis of the GP Group, the transfer of intellectual of property must be examined. In this regard, the legal and economic ownership requires consideration for the transaction between GP Headco and GP Sub 2 within the group.
- Ownership of intangibles and transaction involving the development, enhancement, maintenance, protection and exploitation of intangibles.
- An examination of operating profit allocation to the entities within the GP group to the economic activities generating them.

The substance of the financing arrangement also needs to be examined in terms of the commerciality of the overall arrangement.

The introduction of a new financing arrangement between GP Headco and GP Sub 1 and GP Sub 2 would need to be verified with respect to the arm’s length principle. This would include the overall commercial rationale for the arrangement as well as terms and conditions and the interest rate.

<u>Part 2</u>

Students should reference the OECD Model Tax Convention on Income and Capital (2017), Article 5 – Permanent Establishment.

The term “permanent establishment” means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

A permanent establishment specifically includes:

- A place of management;
- A branch;
- An office;
- A factory;
- A workshop;
- A mine, oil or gas well, quarry or other place of extraction of natural resources; and
- A building suite or a constructional or installation project if the period exceeds 12 months.

Article 5(4) stipulates that a permanent establishment shall be deemed not to include:

- Facilities for storage, display or delivery of merchandise;
- Maintaining goods or merchandise for the purpose of storage, display or delivery;
- Fixed place solely for purchasing goods or merchandise, or collection of information; or
- Activities of a preparatory or auxiliary nature.

Candidates should raise the point that GP Headco may have a permanent establishment in Countries B and C through the activities of GP Sub 1 and GP Sub 2 in terms of the negotiation and conclusion contracts.

Having regard to Article 5(5): notwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph 6, where a person is acting in a Contracting State on behalf of an enterprise and, in doing so, habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and these contracts are:

1) In the name of the enterprise, or

2) For the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or

3) For the provision of services by that enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business (other than a fixed place of business to which paragraph 4.1 would apply), would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

Consideration would also need to be given, depending on the facts and circumstances, that GP Headco has a fixed place of business permanent establishment in either Country B or C (via GP Sub 1 and GP Sub 2, respectively) through the operation of a potential office, branch, factory or workshop. The place of management may also be considered; Article 5(1 & 2).

A services permanent establishment needs to be considered with reference to potential work being performed in Countries B and C.

Students may take the permanent establishment application further to apply Article 7 (business profits) of the OECD Model Tax Convention (2017) which would have implications for the attribution of potential profits to a permanent establishment.

Reference is made to the OECD Guidance on Attribution of Profits to Permanent Establishments (2017). The analysis of the examples included in the Report is governed by the authorised OECD approach OA) contained in the 2010 version of Article 7. 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.

Part B

Question 3

In responding to Parts 1 and 2, candidates may combine their response as they address each of the key transfer pricing issues and risks.

Based on the facts, the key transfer pricing issues and risks are as follows:

- A business restructure is being proposed whereby the key functions, assets and risks are to be transferred from the parent entity of Norfolk (in Country H) to Sub R (in Country R).

- It is proposed that Sub R acquires all of Norfolk's intellectual property (including but not limited to know-how, trademarks and copyrights) and will commence manufacturing operations for the Norfolk group.

- Chapter IX of the 2017 OECD TPG provides guidance on "Transfer Pricing Aspects of Business Restructuring". In this instance, the business restructure involves the centralisation of intangibles, risks and functions with the profit potential attached to them moving from the parent to Sub R.

In answering, candidates are expected to refer to Part I of Chapter IX and briefly explain each of the following:

B. Understanding the restructuring itself

  B.1 Accurate delineation of the transactions comprising the business restricting: functions, assets and risks before the restructuring

  B.2 Understanding the business reasons for and the expected benefits form the restructuring, including the role of synergies

  B.3 Other options realistically available to the parties

  B.4 Transfer pricing documentation for business restructurings

C. Recognition of the accurately delineated transactions that comprise the business restructuring

D. Reallocation of profit potential as a result of a business restructuring

  D.1 Profit potential

  D.2 Reallocation of risks and profit potential

E. Transfer of something of value (e.g. an asset or an ongoing concern)

  E.1 Tangible assets

  E.2 Intangibles

  E.3 Transfer of activity (going concern)

Additional transfer pricing risks which may arise if the transfer pricing optimisation proposal is implemented include:

- Parent not being remunerated at arm's length for the disposal of intangibles to Sub R (refer to section E.2 of Chapter IX and section D.2.1 of Chapter VI). Issues to consider include ensuring that all intangibles transferred are identified and determining the arm's

length consideration. The facts indicate that only a nominal payment will be made. However, the amount must be determined based on the arm's length principle. A market valuation is usually obtained by a qualified valuer with supporting documentation prepared and available to be presented to the tax administration/s as part of transfer pricing documentation.

- In relation to Norfolk Group discontinuing the manufacturing of product on behalf of the group, it possibly should be compensated by Sub R if substantial costs are incurred and for no longer continuing to make profit from this function. For example, manufacturing equipment may need to be disposed at a loss or staff made redundant. In practice, this would depend on if an independent party would expected to be compensated.

- Norfolk parent may be remunerated at arm's length for the $2 billion funds being loaned to Sub R. Refer to the arm's length principle (refer to 2020 OECD Transfer Pricing Guidance on Financial Transactions: Inclusive Framework on BEPS Actions on 4, 8-10). In relation to financial transactions, the same principles contained in Chapters 1-III apply, requiring the accurate delineation of financial transactions. This includes consideration of the contractual terms, functional analysis, characteristic of financial instruments, economic circumstances and business strategies (refer to B.3). C.1 provides guidance on the process for determining whether the interest rate on the loan is arm's length. This will depend on factors such as the credit rating of Norfolk.

Stronger candidates may also reference and explain Chapter VI: Special Considerations for Intangibles in the 2017 OECD Transfer Pricing Guidelines. Key areas which provide guidance based on the facts include:

A. Identifying intangibles

B. Ownership of intangibles and transactions involving the development, enhancement, maintenance, protection and exploitation of intangibles

C. Transactions involving the use or transfer or intangibles

D. Supplemental guidance for determining arm's length conditions in cases involving intangibles

- Specifically, Sub R would be the legal owner of intangible property. However, Parent may continue to perform functions and make decisions related to the intangible property, including undertake R&D.

- Norfolk parent continues to perform R&D related functions. Although it is proposed that Sub R would be the legal owner of the groups intangibles, based on the facts, it is apparent that Norfolk parent will continue to perform functions, possibly use assets or assume risks that are expected to contribute to the value of the intangible/s (further information and analysis would be required). Based on Part B of Chapter VI, consideration needs to be given to the substance of the arrangement regarding which Norfolk entity performs the functions, provides the assets and assumes the risks in relation to the development, enhancement, maintenance, protection and exploitation (DEMPE) of the intangibles.

In relation to the application of the arm's length principle to the transactions following the implementation of the transfer pricing optimisation proposal, Part II of Chapter IX provides guidance on "Remuneration of post-restructuring controlled transactions". Candidates with more comprehensive responses will make reference to and explain:

A. Business restructurings versus "structuring"

  A.1 General principle: no different application of the arm's length principle

A.2 Possible factual differences between situations that result from a restricting and situations that were strutted as such from the beginning

B. Application to business restructuring situations: selection and application of a transfer pricing method for the post-restructuring controlled transactions

C. Relationship between compensation from the restructuring and post-restructuring remuneration

D. Comparing the pre- and post-restructuring situations

- In relation to subsidiaries which purportedly continue to operate as low risk marketing distributors, the arm's length principle must be applied with the identification of commercial or financial relations, the selection of the most appropriate transfer pricing method, a comparability analysis undertaken and contemporaneous documentation prepared.

- In relation to the services which continue to be undertaken by Parent for the benefit of all subsidiaries, Chapter VII: Special Considerations for Inter-Group Services will have application.

- Some students may highlight the fact that the business restructure may be driven by tax reasons, rather than commercial reasons given the substantially lower income tax rate in Country R and the concessions offered by the government.

A range of considerations and questions from the perspective of Country H's tax administration may be raised. Students may raise various issues, with some key ones including:

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

- What are the contractual terms and evidence of the actual conduct of Parent and Sub R before and after the business restructure?

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

    - Where economically relevant characteristics inconsistent with contractual terms, the actual transactions should be identified based on the actual conduct of Parent and Sub R?

- Commercial rationale for undertaking the business restructure.

- Where other options realistically available and were these considered?

- Is the transfer of intellectual property at an arm's length price from Parent to Sub R?

- Does the taxpayer have contemporaneous documentation with an independent valuation supporting the business restructure (including the details the consequence of the profit potential of significant risk allocation)?

- Has the taxpayer undertaken a functional analysis to establish the global value chain and economic substance of Norfolk both before and after the business restructure?

- Is the economic substance consistent with the reallocation of risks?

- Should Parent have been compensated for loss of profit making potential and discontinuation of manufacturing operations?

- Is the royalty paid by Parent to Sub R arm's length.

- Does Sub R continue to make the key decisions relating the Norfolk's intellectual property (a large number of points can be raised with regard to Chapter VI)

Question 4

Parts 1 and 2

In responding, candidates are expected to make reference to Chapter VII: Special Considerations for Intra-Group Services of the 2017 OECD TPG.

Generally, many MNE groups arrange for a wide range of services to be available to its members across the following broad categories:

- Administrative;
- Technical;
- Financial; and
- Commercial services.

The costs may be initially borne or incurred by the parent or designed group members. A member of the MNE group in need of a service may acquire it within the MNE group, source from an independent provider or undertake the service itself.

Before determining the potential chargeable services within Furniture Corp, consideration must be given to whether intra-group services have been rendered (Part B.1 of Chapter VII). The question under the arm's length principle is whether an intra-group service has been rendered when an activity is performed for one or more group members by another group member within the MNE. This includes if the activity provides the group member with economic or commercial value to enhance its business position. This should be determined by considering whether an independent enterprise in comparable circumstances would be willing to pay for the activity if performed for it by an independent enterprise. Alternatively, would it have performed the activity for itself (i.e. recruit staff to undertake or utilise existing resources).

It is acknowledged that limited facts are provided. The answer clearly depends on the actual facts and it is not possible to determine with clarity which services have been provided to group members.

Based on the facts, the following services may be chargeable (references to 2017 OECD TPG):

- Marketing;
- After sales service (call centre);
- Human Resources (para 7.49);
- Financing - accounts receivable, tax and treasury (para 7.49); and
- Information Technology (para 7.49).

Depending on ownership of intellectual property and the groups value chain, certain costs may not be chargeable. The following may or many not be chargeable with further information and details required (students may make appropriate assumptions in responding):

- Research and development (para 7.41)
- Manufacturing, and
- Logistics (depending on terms of trade, e.g. free on board)

Part C of Chapter VII provide a non-exhaustive list of examples of intro-group services in relation to services which should not be charged. Part B.1.1.2 of Chapter VII indicates that shareholder activities may be performed by a group member (usually by the parent or regional holding company) solely because of its ownership interest in one or more other group members i.e. in its capacity as shareholder. This type of activity would not be considered to be an intra-group service and would not justify a charge to another group member. The costs should be incurred or born at the level of the shareholder. Paragraph 7.10 lists examples of costs associated with shareholder activities:

a) Costs relating to juridical structure of parent itself – meetings of shareholders, issuing of shares, stock exchange listings, etc.

b) Costs relating to reporting requirements of parent including financial reporting and audit

c) Costs of raising funds for the acquisition of its participation's and investor relations, financial analyst etc

d) Costs relating to compliance of the parent with tax laws, and

e) Costs which are ancillary to the corporate governance of MNE as a whole.

Other costs which should not be allocated based on OECD TPG include:

- B.1.1 Benefits test – where the group member does not receive a service, a benefit from the service or if an independent party would not have been willing to pay (for example it is already undertaking the activity).

- B.1.3. Duplication – activities undertaken by one group member that duplicates service that another group member is performing for itself or that is already performed by a third-party.

- B.1.4. Incidental benefits – an intra-group service may be performed by a group member such as a shareholder or coordinating centre relates only to some group members but incidentally provides benefits to other group members.

Part 3

Appropriate allocation keys depend on the facts and circumstances. However, the 2017 OECD TPG provide guidance regarding determining the arm's length charge for intra-group services (Part B.2). In summary, charges for intra-group services should be that which would have been made and accepted between independent enterprises in comparable circumstances.

Intra-group services may be charged based on direct (B.2.1) or indirect charge methods (B.2.2). Direct charge relates to services which can be readily identified and for specific services. For example, by recording the work done on an hourly basis or fixed fee, similar to how independent parties may charge.

However, indirect charges can be difficult to apply in practice. Usually this involves a cost allocation or apportionment and requires a degree of estimation or approximation (para 7.23). Such methods should only be used provided specific regard has been given to the value of the services to the recipients and the extent to which comparable services are provided between independent enterprises. The charge could be determined by reference to an allocation among all potential beneficiaries of the costs that cannot be allocated directly, i.e. costs that cannot specifically assigned to the actual beneficiaries of the various services.

To satisfy the arm's length principle, the allocation method must lead to a result that is consistent with what comparable independent enterprises would have been prepared to accept. According to para 7.24 it should be based on an appropriate measure of the usage of the service that is also easy to verify, for example:

- Turnover;
- Staff employed; or
- Another activity-based key such as orders processed.

However, the allocation method will depend on the nature and usage of the service based on the facts and circumstances.

PART C

Question 5

Part 1

In responding, candidates are expected to provide an explanation of Mutual Agreement Procedure (MAP) and arbitration as it applies to MAP.

MAP is a dispute resolution process which allows authorised competent authorities of tax administrations to resolve difficulties in the interpretation or application of a tax treaty. The key article under which MAP discussions occur is Article 25 of the OECD Model Tax Convention. While instigated by the taxpayer, MAP is primarily a process of negotiation between the two tax administrations.

Article 25 gives taxpayers the right to Request MAP where they consider that they have been taxed not in accordance with the convention.

Mandatory binding arbitration is available to taxpayers under some tax treaties. The majority of mandatory binding arbitration has been implemented by the Multilateral Instrument. However, some has been introduced in the treaty itself. Mandatory binding arbitration allows taxpayers to request that their MAP case is resolved through arbitration where competent authorities have been unable to do so within a certain period of time, which is generally two years. Once the taxpayer has requested arbitration, the MAP case is resolved by a panel of independent arbitrators who reach a decision on the resolution of the case. This decision is then implemented by the tax administrations as the MAP agreement.

Generally, mandatory binding arbitration has ensured that competent authorities have actively managed time frames to ensure that their case does not become eligible for arbitration. It is likely that MAP cases will be resolved within a two year timeframe with cases progressing to arbitration where one tax administration views that the case cannot be negotiated on reasonable terms. However, this may only be applicable where both jurisdictions have adopted arbitration. If they have not adopted, the timeframes to resolve the MAP may be greater than two years or alternatively, the taxpayer may be subject to double taxation if a resolution cannot be reached.

Tax administrations have an obligation to undertake annual reporting on MAP statistics to the OECD Secretariat, which are released each year.

In summary, mandatory binding arbitration, if adopted by jurisdictions is likely to reduce the average timeframes to resolve MAP cases with only the most complex and material cases progressing to arbitration.

Part 2

On 8 October 2021, members of the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting (BEPS) agreed to the Statement on the Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation for the Economy. This follows years of detailed and intensive work by the OECD and Inclusive Framework members to bring the international tax rules into the 21st century.

Broadly, the Two-Pillar Solution will ensure that multilateral enterprises will be subject to a minimum tax rate of 15% and will re-allocate profit of the largest and most profitable MNEs to countries worldwide. As at November 2021, 136 jurisdictions of the 140 members of the Inclusive Framework, representing more than 90% of global GDP, have joined the Two-Pillar Solution. A new framework and Detailed Implementation Plan envisages that the new rules will be implemented in 2023.

Pillar One aims to ensure a fairer distribution of profits and taxing rights among countries with respect to the largest MNEs. Taxing rights over 20% of the residual profit (in excess of 10%) of

in scope MNEs will be re-allocated to the jurisdictions where the customers and users of the MNEs are located. Tax certainty is a key aspect, which includes a mandatory and binding resolution process but with the caveat that developing countries will able to benefit from an elective mechanism in certain cases. The agreement includes the removal and standstill of Digital Services Tax and other relevant, similar measures. It provides a simplified and streamlined approach to the application of the arm's length principle in specific circumstances (Amount B), with a practical focus on the needs of low-capacity countries.

Pillar Two places a floor on tax competition on corporate income tax through the introduction of a global minimum corporate tax rate of 15% that countries can use to protect their tax based (the GloBE rules). Pillar Two also protects the right of developing countries to tax certain base-eroding payments (like interest and royalties) when they are not tax up to the minimum rate of 9%, through a "Subject to tax rule" (STTR). Certain care-outs accommodate tax incentive for substantial business activities.

Pillar One and Pillar Two are subject to further negotiation and consultation in 2021 and early 2022 by Inclusive Framework members.

Part 3

Article 5 of the OECD Model Convention with Respect to Taxes on Income and on Capital (Model Convention) covers Permanent Establishment (PE). A PE is regarded as a fixed place of business through which the business of an enterprise is wholly or partially carried on.

It specifically includes:

- A place of management;
- A branch;
- An office;
- A factory;
- A workshop;
- A mine, oil or gas well, quarry or other place of extraction of natural resources; and
- A building suite or a constructional or installation project if the period exceeds 12 months.

If a person (other than an independent agent) is acting on behalf of an enterprise and habitually concludes contracts for that enterprise in another country, they may have a PE in that jurisdiction.

However, there are certain exclusions to a PE broadly including:

- Facilities for storage, display or delivery of merchandise;
- Maintaining goods or merchandise for the purpose of storage, display or delivery;
- Fixed place solely for purchasing goods or merchandise or for collection information; or
- Activities of a preparatory are auxiliary nature.

Article 7 of the Model Convention covers "Business Profits" and states that business profits are only taxable if business is carried out through a PE in the other contracting state/jurisdiction. Under transfer pricing rules, profit must be attributed to the PE as if it were a separate and independent enterprise. Therefore, the arm's length principle should apply to PE's taking into account the functions performed, assets used and risks assumed.

Question 6

Part 1

The OECD/G20 BEPS final report on Action 14 – Making Dispute Resolution More Effective issued in 2015.

The measures developed under Action 14 aim to strengthen the effectiveness and efficiency of the Mutual Agreement Procedure (MAP) process. They aim to minimise the risks of uncertainty and unintended double taxation by ensuring the consistent and proper implementation of tax treaties, including the effective and timely resolution of disputes regarding their interpretation or application through MAP.

A number of countries agreed to important changes in their approach to dispute resolution, in particular by having developed a minimum standard with respect to the resolution of treaty-related disputes, committed to its rapid implementation and agreed to ensure its effective implementation through the establishment of a robust peer-based monitoring mechanism.

The Action 14 final report listed 17 elements of the Minimum Standard and 11 Best Practices.

Best practice 4 suggests that jurisdictions should implement bilateral Advance Pricing Arrangement (APA) programmes.

Paragraph 48 states:

> *"An advance pricing arrangement (APA) is an "arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (e.g. method, comparables and appropriate adjustments thereto, critical assumptions as to future events) for the determination of the transfer pricing for those transactions over a fixed period of time". See paragraph 4.123 of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. APAs concluded bilaterally between treaty partner competent authorities provide an increased level of certainty in both jurisdictions, lessen the likelihood of double taxation and may proactively prevent transfer pricing disputes. Countries should accordingly seek to implement bilateral APA programmes as soon as they have the capacity to do so."*

Candidates may support implementing an APA programme or not. A number of key considerations (non exhaustive) for jurisdictions include:

Taxpayer certainty (for taxpayer and tax administration)

One of the most important purposes of APAs is to provide certainty to taxpayers on the tax treatment of their cross-border transactions. An APA provides comfort to a taxpayer that it will not be subject to a resource and costly audit, with an uncertain outcome, in relation to the relevant transaction(s) that fall within the APA, and over the period of the APA. Bilateral or multilateral APAs extend that comfort to the treatment of the relevant transactions in more than one country, and also provide for protection against double taxation.

Likely tax collections

APAs should not be viewed as a means for increasing tax revenue. As mentioned above, APAs are primarily aimed at providing some certainty to taxpayers on the tax treatment of their cross-border activities. From the perspectives of both the taxpayer and the tax authority, an APA is often seen as an alternative to an audit. If a tax administration has the capacity to carry out effective audits, it is unlikely that devoting resources to APAs will be more effective at raising revenue than employing resource on audits.

Resources and specialist knowledge

There are a number of considerations with regards to the most efficient use of tax authority resources. It is important to note that the negotiation of an APA needs to be carried out by knowledgeable transfer pricing specialists in the tax administration. Such resources are likely to be in short supply, and, when directed towards an APA, will have reduced availability for other compliance activities, including transfer pricing audits. Tax administrations thus often face a balance between using scarce resources in an APA programme and compliance or audit activity.

Capability building

Taxpayers' incentive to co-operate with the APA process and increased willingness to work with the tax administration often means that involvement in negotiating APAs can help build valuable specialist transfer pricing skills, and build knowledge and intelligence on industries and the largest taxpayers.

Capacity to conduct an APA programme

It is sometimes argued that less experienced tax administrations may lack the knowledge and skills to negotiate fair APAs, especially when faced with large, well-advised MNEs and their advisors. Similarly, in the case of bilateral and multilateral APAs, there is a perceived risk that less experienced countries may be disadvantaged in negotiations by more experienced countries.

Treaty network

If a jurisdiction does not have a broad number tax treaties, any APA programme would be limited to mostly unilateral APAs. Taxpayers may be less included to enter into a unilateral APA if there is risk of double taxation or complete transactions.

Candidates may advocate for adoption of an APA programme or not adopt based on the facts and circumstances of the jurisdiction. However, candidates are expected to raise the above issues in responding.

Part 2

The OECD/G20 Base Erosion and Profit Shifting Project (BEPS) Action 13 Final Report related to Transfer Pricing Documentation and Country-by-Country Reporting.

Action 13 related to the development of "rules regarding transfer pricing documentation to enhance transparency for tax administration, taking into consideration the compliance costs for business. The rules to be developed will include a requirement that MNEs provide all relevant governments with needed information on their global allocation of the income, economic activity and taxes paid among countries according to a common template".

In response to this requirement, a three-tiered standardised approach to transfer pricing documentation was developed.

First, the guidance on transfer pricing documentation requires MNEs to provide tax administrations with high-level information regarding their global business operations and transfer pricing policies in a "master file" that is to be available to all relevant tax administrations.

Second, it requires that detailed transactional transfer pricing documentation be provided in a "local file" specific to each country, identifying material related party transactions, the amounts involved in those transactions, and the company's analysis of the transfer pricing determinations they have made with regard to those transactions.

Third, large MNEs are required to file a Country-by-Country Report that will provide annually and for each tax jurisdiction in which they do business the amount of revenue, profit before

income tax and income tax paid and accrued. It also requires MNEs to report their number of employees, stated capital, retained earnings and tangible assets in each tax jurisdiction. Finally, it requires MNEs to identify each entity within the group doing business in a particular tax jurisdiction and to provide an indication of the business activities each entity engages in.

Taken together, these three documents (master file, local file and Country-by-Country Report) require taxpayers to articulate consistent transfer pricing positions and will provide tax administrations with useful information to assess transfer pricing risks, make determinations about where audit resources can most effectively be deployed, and, in the event audits are called for, provide information to commence and target audit enquiries. This information should make it easier for tax administrations to identify whether companies have engaged in transfer pricing and other practices that have the effect of artificially shifting substantial amounts of income into tax-advantaged environments.

The countries participating in the BEPS project agree that these new reporting provisions, and the transparency they will encourage, will contribute to the objective of understanding, controlling, and tackling BEPS behaviours.

A number of key considerations for the tax administration include:

Confidentiality

Jurisdictions should have in place and enforce legal protections of the confidentiality of the reported information. Such protections would preserve the confidentiality of the Country-by-Country Report to an extent at least equivalent to the protections that would apply if such information were delivered to the country under the provisions of the Multilateral Convention on Mutual Administrative Assistance in Tax Matters, a Tax Information Exchange Agreement (TIEA) or a tax treaty that meets the internationally agreed standard of information upon request as reviewed by the Global Forum on Transparency and Exchange of Information for Tax Purposes.

Consistency

Jurisdictions should use their best efforts to adopt a legal requirement that MNE groups' ultimate parent entities resident in their jurisdiction prepare and file the Country-by-Country Report, unless exempted.

Appropriate Use

Jurisdictions should use the information appropriately contained in the Country-by-Country Report template. In particular, jurisdictions must commit to use the Country-by-Country Report for assessing high-level transfer pricing risk. Jurisdictions should not propose adjustments to the income of any taxpayer on the basis of an income allocation formula based on the data from the Country-by-Country Report.

Exchange of Information

Jurisdictions should require in a timely manner Country-by-Country Reporting from ultimate parent entities of MNE groups resident in their country and exchange this information on an automatic basis with the jurisdictions in which the MNE group operates.

Domestic legislation

Implement with a requirement that the ultimate parent entity of an MNE group file the Country-by-Country Report in its jurisdiction of residence. Jurisdictions can adapt the OECD developed model legislation to their own legal systems and make changes as required.

Resources and adoption into law

Domestic systems and international agreements for the automatic exchange of the Country-by-Country Reports under international agreements have been developed and must be put in place. This includes competent authority agreements based on international agreements (i.e. the Multilateral Convention on Mutual Administrative Assistance in Tax Matters, bilateral tax treaties and TIEAs). This is likely to take up resources of the tax administration, finance department and other government officials and representatives.

Question 7

Part 1

As is acknowledged in paragraph 1.13 of the OECD TPG:

> *"Both tax administrations and taxpayers often have difficulty in obtaining adequate information to apply the arm's length principle. Because the arm's length principle usually requires taxpayers and tax administrations to evaluate uncontrolled transactions and the business activities of independent enterprises, and to compare these with the transactions and activities of associated enterprises, it can demand a substantial amount of data. The information that is accessible may be incomplete and difficult to interpret; other information, if it exists, may be difficult to obtain for reasons of its geographical location or that of the parties from whom it may have to be acquired. In addition, it may not be possible to obtain information from independent enterprises because of confidentiality concerns. In other cases information about an independent enterprise which could be relevant may simply not exist. It should also be recalled at this point that transfer pricing is not an exact science but does require the exercise of judgement on the part of both the tax administration and taxpayer."*

Due to consolidation in a number of industries and regions, independent companies can be rare or non-existent. Consideration needs to be given as to how to determine arm's length pricing in such circumstances.

In the absence of CUPs, consideration of the comparables' circumstances is required. This applies both to internal and external comparables and will generally apply no matter the transfer pricing method (whether a cost plus, resale minus or TNMM approach is adopted). It is therefore usually necessary, even in relation to internal comparables, to obtain and consider data about the potential comparable. Often the amount of information held internally is limited and external data is required to be obtained. However, obtaining such data can be difficult or impossible for MNEs and tax administrations alike.

The OECD has noted that the amount of descriptive data about a company's activities contained in many publicly available databases used for comparability purposes can be limited. While this can in some cases be supplemented by a review of websites, the amount of data about the activities undertaken and risks borne by a company provided by such websites can vary and is often low.

In summary, there may be problems in obtaining data about both internal and external comparables. In many cases, these will be impossible to resolve. Many comparisons will therefore involve a degree of uncertainty and/or will involve inexact comparables.

Tax administrations may have access to detailed but confidential information, e.g. from independent enterprise tax returns or audits, that is unavailable to the taxpayer or to the public. The recourse to confidential information by a tax administration follows from the information asymmetry situation which exists between taxpayers and tax administrations. In particular, some administrations lacking public sources of information might have a practice to use information obtained on other taxpayers through audits or other sources which are treated as confidential. Such information qualifies as "secret comparables" because confidentiality rules would prevent administrations to disclose the identity of these other taxpayers.

Many commentators and advisors have expressed concerns with regard to the use of "secret comparables" which they regard as unfair and lacking transparency. The use is contrary to the obligation on both taxpayers and tax administrations to make a "good faith showing" that the determination of transfer pricing is consistent with the arm's length principle.

Most tax administrations recognise that the use of "secret comparables" in transfer pricing adjustments raise a number of concerns including:

- Fairness and transparency of the process, including the ability of the taxpayer not being able to prepare its defence;

- Obligation of confidentiality with third-party data may not be permitted under country domestic legislation;

- Whether secret comparables can ever be used to legitimise a transfer pricing adjustment where the taxpayer is not in a position to agree or disagree on a secret comparable; and

- Whether such secret comparables can validly be used in competent authority procedures in Mutual Agreement Procures or negotiating bilateral APAs.

Paragraph 3.36 (A.4.3.3 – Information undisclosed to taxpayers) states:

> *"Tax administrations may have information available to them from examinations or other taxpayers or from other sources of information that may not be disclosed to the taxpayer. However, it would be unfair to apply a transfer pricing method on the basis of such data unless the tax administration was able, within the limits of its domestic confidentiality requirements, to disclose such data to the taxpayers so that there would be an adequate opportunity for the taxpayer to defend its own position and to safeguard effective judicial control by the courts."*

Therefore, the OECD strong suggests the use of "secret comparables" by tax administrations to apply a transfer price adjustment.

<u>Part 2</u>

In December 2020, the OECD issued "Guidance on the transfer pricing implications of the COVID-19 pandemic" (COVID Guidance). This guidance represents the consensus view of the members of the Inclusive Framework on BEPS regarding the application of the arm's length principle and the OECD TPG to issues that may arise or be exacerbated in the context of the COVID-19 pandemic. The guidance is helpful both for taxpayers in reporting the financial periods affected by the pandemic and for tax administrations in evaluating the implementation of taxpayers' transfer pricing policies.

The COVID Guidance provides clarifying comments on, and illustrations of, the practical application of the arm's length principle in four priority issues:

- Comparability analysis;
- Losses and the allocation of COVID-19 specific costs;
- Government assistance programmes; and
- Advance pricing agreements.

The unique economic conditions arising from COVID-19 and government responses to the pandemic have led to practical challenges for the application of the arm's length principle. For taxpayers applying transfer pricing rules for the financial years impacted by the COVID-19 pandemic and for tax administrations that will be evaluating this application, there is a need to address these practical questions. The OECD TPG assist tax administrations and MNEs to find solutions to transfer pricing cases and should continue to be relied upon when performing a transfer pricing analysis, including under the unique circumstances introduced by the pandemic. However, the COVID Guidance supplements the OECD TPG in the face of the COVID-19 pandemic.

The COVID Guidance focuses on how the arm's length principle and the OECD TPG apply to issues in the context of the COVID-19 pandemic, rather than on developing specialised guidance beyond what is currently addressed in the OECD TPG. For example, the pandemic may raise novel issues or exacerbate in complexity or magnitude the occurrence of certain transfer pricing issues (e.g. effect of government assistance or the availability of reliable comparable data).

In order to determine whether an entity should be allocated losses during the pandemic under arm's length conditions, the guidance in Chapter II of the COVID Guidance is relevant, but the guidance in Chapter I of the OECD TPG as it relates to the results of the comparability analysis continues to be relevant. Further, taxpayers and tax administrations should carefully follow the guidance on the accurate delineation of controlled transactions in Chapter I of the OECD TPG to identify with specificity the economically significant risks and to determine the specific economically significant risks that each party to a controlled transaction assumes.

Chapter 1 of the COVID Guidance covers comparability analysis.

It acknowledges that the unprecedented change in the economic environment following the outbreak of COVID-19 creates unique challenges for performing comparability analysis. The pandemic may have a significant impact on the pricing of some transactions between independent enterprises and may reduce the reliance that can be placed on historical data when performing comparability analyses.The challenges associated with performing a comparability analysis may vary depending on the impact of the COVID-19 pandemic on the economically relevant characteristics of the accurately delineated transaction.

The accurate delineation of a controlled transaction will determine the effect, if any, of intervention on the price or form of any controlled transaction associated with activities. This aspect is also relevant in performing the comparability analysis. In undertaking a benchmark analysis, care should be taken in verifying that comparable enterprises have faced similar restrictions or conditions. Otherwise, it might be necessary to adjust the period over which the comparison is performed (e.g.excluding the economic data corresponding to the three months where four example a taxpayer was unable to operate). Taxpayers and tax administrations should determine on a case-by-case basis the extent to which these adjustments are necessary in circumstances where the potential differences may not have a material impact on the comparability. In this respect, the guidance in paragraphs 3.50 to 3.52 of the OECD TPG is relevant.

Specifically in relation to use of loss making comparables, paragraph 33 of the COVID Guidance states:

> *"In general, there is no overriding rule on the inclusion or exclusion of loss making comparables in the OECD TPG. Accordingly, loss-making comparables that satisfy the comparability criteria in a particular case should not be rejected on the sole basis that they suffer losses in periods affected by the COVID-19 pandemic. Consequently, when performing a comparability analysis for FY 2020, it may be appropriate to include loss-making comparables when the accurate delineation of the transaction indicates that those comparables are reliable (e.g. the comparables assume similar levels of risk and that have been similarly impacted by the pandemic)."*

<u>Part 3</u>

MNEs account for approximately 60% of world trade and the relationship between Customs duty valuation and transfer pricing is becoming a more significant issue. Transfer pricing policies can significantly include the levels of Customs duty and indirect taxes governs collect and MNEs profitability.

However, aligning the transfer pricing and the Customs treatment has proven challenging for MNEs from a legal and practical perspective. Whilst transfer pricing polices can generally be applied by MNEs for consistency on a global scale (largely due to the OECD TPG), the Customs treatment may require a different approaches to cater for the individual requirements adopted by the Customs authorities in each jurisdiction.

The approach for determining the Customs value for imported goods is set out in the Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade. However, for transfer pricing purposes, MNEs are required to ensure that the pricing of their related party transactions are based on the arm's length principle.

Paragraph 1.137 of Chapter I of the OECD TPG confirms that the arm's length principle is applied by many customs administrations as a comparison between the value attributable to goods imported by associated enterprises, and the value for similar goods imported by independent enterprises. Valuation methods for customs purposes may not be aligned with the OECD transfer pricing methods. However, customs valuations may be useful to tax administrations in evaluating the arm's length character of an independent transaction.

In addition, business representatives who have responded to the OECD's invitation to comment on this issue have drawn attention to the difficulties caused by transfer pricing adjustments in areas beyond transfer pricing, e.g. VAT, customs, excise taxes, and regulatory requirements (e.g. price of drugs) and some of them have advocated that the OECD provide further guidance on these issues. In particular the impact of transfer pricing adjustments on VAT and customs duties is becoming an increasingly important issue in many OECD countries.

Question 8

Part 1

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:

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

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

3) 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 a audit. This is important given the limited resources of tax administration in order to be targeted.

Part 2

Candidates should define a Cost Contribution Arrangement (CCA), its application and articulate the advantages of a CCA, as well as describe situations whereby a CCA may not be appropriate, 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.

Stronger 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 9

Part 1

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 (lenders' and borrowers' perspectives, 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.

Part 2

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.

Consideration could be given to the arm's length debt test of an entity being a notional amount applied to a hypothetical business that would satisfy both of the following two tests:

- The notional debt capital the entity "would reasonably be expected to have throughout the income year" (the borrower's test).

- Arrangements that unrelated commercial lending institutions would "reasonably be expected to have entered into" (the lender's test).

Issues to be noted in connection to the ALDT as as follows:

- Terms and conditions;
- Credit rating/worthiness;

- Covenants;
- Consideration of the relevant factors;
- Quantitative factors;
- Return on equity capital;
- Gearing;
- Commercial rationale for related party debt; and
- Documentation and analysis to support the ALDT.

Part 3

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.