THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

June 2023

MODULE 3.03 – TRANSFER PRICING OPTION

SUGGESTED SOLUTIONS

PART A

Question 1

Part 1

Chapter 1 of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, July 2017 (OECD TPG) addresses the arm's length principle.

In order to apply the arm's length principle, this requires a comparison of the conditions in the controlled transaction (i.e. between associates within the multinational group) with the conditions that would have been made had the parties been independent and undertaking a comparable transaction under comparable circumstances. It is essential to identify the commercial or financial relations between the associated enterprises (i.e., related entities in the multinational group) and the conditions and economically relevant circumstances attaching to those relations to accurately delineate the controlled transaction. Secondly, there is a need to compare the conditions and the economically relevant circumstances of the controlled transaction as accurately delineated with the conditions and the economically relevant circumstances of comparable transactions between independent enterprises.

In relation to the facts provided in respect of National Group, the delineated transactions between members of the group will have been deduced from written contracts and the actual conduct of the associated parties and the other economically relevant characteristics of the transactions (Section D.1.1 of OECD TPG).

ZeusCo:

- Conducts research and development to develop intangibles on behalf of the Group, including for use by AresCo and HeraCo
- Carries on treasury function (i.e. management of cash and financing activities) on behalf of the Group, including AresCo and HeraCo
- Carries on logistics function on behalf of the Group, including AresCo and HeraCo
- Carries on strategic management and administration on behalf of the Group, including AresCo and HeraCo
- Sale of finished goods to AresCo

AresCo:

- Purchase of finished goods from ZeusCo
- Receipt of services from ZeusCo including strategic management, administration, and treasury

HeraCo:

- Conducts contract manufacturing for ZeusCo
- Licence of intangibles, including manufacturing known how from ZeusCo

As limited facts are provided, it is reasonable for candidates to assume that additional transactions in relation to the core functions of the Group may also be undertaken by the associated entities, although this is not explicitly indicated in background material provided.

Part 2

Chapter II of the OECD TPG addresses the selection of the transfer pricing method, which is based on the facts and circumstances of the particular case. The appropriateness of the method should be determined through a functional analysis and will depend on the availability of reliable information and the degree of comparability between controlled and uncontrolled transactions, including number of comparability adjustments that may be needed to eliminate material differences.

Candidates are expected to provide reasons justifying their selection of the most appropriate transfer pricing method/s having regard to the facts available.

In relation to services conducted by ZeusCo to AresCo and HeraCo, cost plus method is likely to be the most appropriate method. Some candidates may reference Chapter VII of the OECD TPG which applies to intra-group services. B.1.5 of the OECD TPG provides guidance on centralised services, which based on the available facts is likely to have application as one or more group service centres are made available to group members. Better candidates will refer to determining the arm's length charge (direct and indirect charge methods). It is reasonable to assume that some services may be low value-adding services, with a 5% mark-up applying on the relevant cost base under the OECD simplified approach. Under the simplified approach, there is no requirement to undertake a supporting benchmarking study (D2.4).

The cost plus method may also apply to the contract manufacturing arrangement undertaken by HeraCo. Alternatively, it may be possible to apply the transactional net margin method (TNMM) with a return on assets being appropriate.

In relation to the sales of finished goods by ZeusCo to HeraCo, the facts indicate that ZeusCo also sells finished goods to independent parties. The application of the methodology will likely depend on other factors which may have a material effect on price i.e. such as type of product, volumes and whether the markets are similar. The appropriate method is likely to be the comparable uncontrolled (CUP) method, which is the most direct and reliable way to apply the arm's length principle and is generally preferable over all other methods.

Part 3

Candidates may articulate a number of different risks which are valid based on the facts.

One of the most significant risks is the margin made by AresCo, which is potentially not arm's length. Based on the CbC data provided in the facts, AresCo makes a 25% profit margin and also has the largest value of sales of any entity in the group. AresCo also has the lowest number of employees and assets of entities within the group. Based on the facts provided, AresCo is likely to be a distributor of goods, but makes a profit which may not be commensurate with its functions, assets and risks. For example, ZeusCo which sells finished products to AresCo and targets a net profit margin on sales to independent or uncontrolled parties of 20% (based on $35m of sales), which is a lower margin that AresCo. AresCo sources all product from another associate. Based on this information, indications are that AresCo is purchasing finished goods from ZeusCo may not be arm's length.

Question 2

A functional analysis is defined by the OECD TPG (D.1.2) as "the analysis aimed at identifying the economically significant activities and responsibilities undertaken, assets used or contributed, and risks assumed by the parties to the transactions".

It is acknowledged that limited factual information is available to candidates and that in order to undertake a comprehensive functional analysis, additional information would need to be obtained on Rascal, including likely undertaking functional interviews. Candidates may also appropriately identify other functions, assets and risks - i.e., the list below is not comprehensive.

IP Co

Functions:

- Management of intellectual property for group
- Provides finance for all associates

Assets:

- Cash
- intellectual property
- Staff

Risks:

- Regulatory risk (relies on all markets to generate royalty)
- Trademark and other intellectual property infringement
- Financial risk (substantial loans)

Procure Co

Functions:

- Procure inputs into the production and manufacture of soft drinks/soda
- Arrange for insurance and transport/logistics from third party to associate which undertakes manufacturing (Man Co)

Assets:

- Manufacturing inputs and consumables (bulk liquid sugar, preservative, cardboard, plastic bottles, aluminium cans). It is assumed that flash title is held i.e. whilst in transit between independent party and Man Co
- Administration and procurement staff
- Office (leased)
- Information technology equipment, telephones and office equipment
- Staff

Risks:

- Currency/foreign exchange risk
- Other risks are likely, but challenging to identify based on facts provided
- Classification: low risk procurement entity for associates

Man Co

Functions:

- Production and manufacture of soft drink/soda

- Procurement of carbon dioxide
- Arrange for logistics/transportation of finished goods to Distribution Co

Assets:

- Manufacturing and packaging inputs (bulk liquid sugar, preservative, cardboard, plastic bottles, aluminium cans, carbon dioxide)
- Plant and equipment to manufacture
- Land and buildings
- Staff

Risks:

- Obsolescence risk for inputs
- Currency/foreign exchange risk
- Risk of equipment failure
- Hazard and occupational health and safety risk
- Operational risk (i.e. electricity failure, unable to source water etc)
- Financial risk associated with loans (possibly currency risk)
- Risk that IP Co will not continue to grant licence
- Classification: fully fledged manufacturer of food products with medium risk

Distribution Co

Functions:

- Distribution, marketing and sale of finished goods in territory
- Development of marketing material for territory
- Forecasting future demand

Assets:

- Office premises with information technology, telephones
- Sales and marketing staff
- Motor vehicles
- Warehouse for storage of goods (leased)

Risks:

- Bad debt risk (limited if long term and major customers)
- Obsolescence risk
- Financial risk - credit worthiness of customers (linked to bad debt risk)
- Market risk
- Classification: fully fledged distributor and marketer of food products

Part 2

Comparability is a key concept in transfer pricing and is critical to apply the arm's length principle. Chapter III of the OECD TPG provides guidance in respect of comparability. The arm's length principle is based on a comparison of the conditions in a controlled transaction (i.e. between associates) with the conditions that would have been made had the parties been independent and undertaking comparable transaction under comparable circumstances.

Prior to undertaking a comparability analysis, it is essential to identify the commercial or financial relations between the associated enterprises and the conditions and economically relevant circumstances attaching to those relations to accurately delineate. Further, one should compare the conditions and economically relevant circumstances of the tested transactions as accurately delineated with independent parties.

A comparability analysis aims at finding the most reliable comparables as part of the applying the most appropriate transfer pricing method. Thus, the availability of comparables will be a determinative factor in the process of the selection of the most appropriate transfer pricing method/s.

Based on the facts provided and the classification of each entity in the Rascal group, a comparability analysis on each entity would need to be undertaken (which will differ based on the functional analysis and functional classification).

Part 3

Based on the facts, IP Co legally owns all intellectual property for Rascal group, including trademarks, copyright, designs, know-how, patents and manufacturing process. IP Co presumably develops, exploits and maintains the intellectual property for the group (i.e. undertakes DEMPE functions).

IP Co grants a right to each Man Co to compensate or remunerate it for allowing the associated entity to utilise the intellectual property, which is presumably the key recipe for soft drinks, designs for packaging, copyright and manufacturing know how for use in their territory.

The arrangement for payment of royalty would seem to be reasonable and consistent with the OECD Model Tax Convention with Respect to Taxes on Income and on Capital (OECD MTC), Article 12 on Royalties:

The term “royalties” as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.

Further, although a functional analysis and comparability analysis would need to be undertaken on Man Co, the 3% margin does not seem unreasonable. However, a profit level indicator based on assets may be more appropriate than sales as Man Co presumably has significant assets (refer to para 2.103-2.104 of OECD TPG for further details).

Based on the facts available, it is acknowledged that limited information is available and further information from Rascal group would need to be obtained to form a more considered view.

PART B

Question 3

Candidates may 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:

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)

A full functional analysis would be required for all entities to establish the global value chain and economic substance of the MP group pre and post restructure. Identification of 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).

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.

Candidates may make certain assumptions given the list of facts provided is not exhaustive, but would be expected to apply the facts to a functional analysis in terms of 'pre and post restructuring' for the entities within the MP Group and also characterise them. Candidates may also mention any comparability issues in terms of selection and application of a transfer pricing method for the post-restructuring controlled transactions. Candidates should make reference to the OECD Transfer Pricing Guidelines (2017), Chapter II: Transfer Pricing Methods.

Entity	Pre-Restructuring	Post-Restructuring
MP Headco	Functions: Manufacturing and production, warehousing, procurement, research and development, distribution, IP holder. Assets: IP, property, plant and equipment, marine equipment, staff, offices, warehouses. Risks: Operational, obsolescence, market, financial, manufacturing, bad debt, IP, inventory. Characterisation: Fully-fledged manufacturer of marine engines and IP holder.	Functions: Manufacturing and production, warehousing, procurement, research and development, distribution. Assets: Property, plant and equipment, marine equipment, staff, offices, warehouses. Risks: Operational, obsolescence, market, financial, manufacturing, bad debt, inventory. Characterisation: Fully-fledged manufacturer of marine engines.
MP Sub 1	Functions: Procurement, distribution, retailing, Assets: Warehouses, retail outlets, staff, inventory, offices. Risks: Inventory, market, financial, obsolescence, operational, inventory. Characterisation: Full-fledged distributor and retailer of marine engines.	Functions: Procurement, distribution, retailing. Assets: Warehouses, retail outlets, staff, inventory, offices. Risks: Inventory, market, financial, obsolescence, operational, inventory. Characterisation: Full-fledged distributor and retailer of marine engines.
MP Sub 2	N/A	Functions: IP holder, administrative and technical services, research and development, financing. Assets: IP, staff, offices. Risks: Financing, IP, market. Characterisation: IP holder and services provider with research and development.
MP Sub 3	N/A	Functions: Manufacturing, procurement, distribution. Assets: Property, plant and equipment, staff, offices, warehouses. Risks: Market, inventory, obsolescence, operational. Characterisation: Contract manufacturer.

Candidates should make reference to the OECD Transfer Pricing Guidelines (2017), Chapter II: Transfer Pricing Methods. Comparability needs to be considered in terms of post restructure. Candidates may outline the various methods available and potential application. Transactions such as profitability may be considered utilizing a TNMM, royalties a CUP, resale price for on-selling of finished goods, services and contract manufacturing a cost plus.

Part 2

Candidates may identify potential transfer pricing risks including:

- Is the transfer of intellectual property at arm's length? What is the commercial rationale for the transfer?
- Valuation issue in relation to the arm's length compensation for transfer of intellectual property.
- Economic versus legal ownership of IP and DEMPE functions.
- Arm's length nature of the royalties paid associated with intellectual property.
- What are the contractual terms between the parties (pre and post restructure)?
- Has there been documentation that demonstrates the decision making process to reallocate risk (including the details the consequence of the profit potential of significant risk allocation)? Is the economic substance in line with the reallocation of risks? This includes examining the changes to the functions of the entities in the MP Group and the associated changes in risks leading to potential characterisation changes.
- Buy-out payments?
- 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?
- Profit shifting to lower tax jurisdictions with a significant decline in profitability in higher tax jurisdictions.

Question 4

Part 1

Candidate 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 for collection of information, or
- Activities of a preparatory or auxiliary nature.

The facts applicable to the Ocean Dream group should be applied in relation to the Article 5 of the OECD Model Tax Convention (2017) and the relevant permanent establishment article in a Double Taxation Agreement (treaty) between Fisherman's Cove and Relax Isle.

Candidates may argue that Ocean Dream Ltd has a fixed place of business permanent establishment in Relax Isle through the operation of an office. The place of management may also be conducted in Relax Isle staff instrumental to the conduct of the project - Article 5(1&2).

A dependent agent permanent establishment may be created with reference to Article 5(5) as decision makers of Ocean Dream sign contracts relevant to the project conducted in Relax Isle.

The project being undertaken by Ocean Dream (development and implementation of an electronic border protection system for the Customs Agency) in Relax Isle may give rise to a permanent establishment - Article 5(3) – if it is a project lasting more than 12 months.

Candidates may identify that the project activities are being split up between different associated companies of Ocean Dream. Also, staff employed by Ocean Dream are completing work in Relax Isle for periods no longer than 30 days at a time. This may indicate that separate activities relate to a holistic project and therefore a permanent establishment.

Candidates may highlight that the anti-fragmentation rules, noting Article 5(4), may apply to the Ocean Dream group. Staff employed by Ocean Dream undertake work in Relax Isle on a 'fly in fly out' basis for a period of no longer than one month at a time. This may result in the overall combination of activities carried out in Relax Isle resulting in a permanent establishment for Ocean Dream Ltd.

A services permanent establishment may also exist, applicable to the staff employed by Ocean Dream, performing work in Relax Isle.

Better candidates may raise an issue associated with income generated from customers in Relax Isle in connection with the boat charter activity. This income being booked outside of

Relax Isle that may be attributed to sales from customers in Relax Isle. Also, the existence of an online platform and issues related to the taxation of the digital economy.

Part 2

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) 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 3

Transfer pricing issues in relation to intellectual property, having regard to DEMPE may exist in this particular case.

The project being undertaken by Ocean Dream in Relax Isle includes research and development activities as well as product and technical services. It is also noted that biometrics engineers are undertaking services.

Candidates may raise issues in relation to activities in relation to the development of intellectual property (economic ownership) in Relax Isle whilst the legal ownership being in Fisherman's Cove. To that end, there may be profits and royalties attached to the legal ownership of the intellectual property rather than compensation being received by the economic owner of the intellectual property. The research and development activities may be economically contributing to the generation of the functionality and profits derived from them. In addition, the other DEMPE functions may be not conducted by the legal owner of the intellectual property.

PART C

Question 5

Part 1

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

Candidates may refer to the OECD's Transfer Pricing Guidance on Financial Transactions (Inclusive Framework on BEPS: Actions 4, 8-10.

Candidates should list key transfer pricing risks/issues in relation to intra-group financial transactions.

- Whether a purported loan should be treated as a loan.
- Identification of the commercial and financial relations.
- The economically relevant characteristics of actual financial transactions.
- Treasury function.
- Intra-group loans (lender and borrowers perspective, credit ratings, group membership, covenants, guarantees, fees and charges, cost of funds – arm's length interest rate, arm's length conditions).
- Cash pooling (arm's length price).
- Hedging (examination of risks).
- Financial guarantees (economic benefits, group membership, financial capacity of guarantor, arm's length price.
- Captive insurance (assumption of risk, arm's length price).
- Risk-free and risk-adjusted rates of return.

Candidates should use relevant case law to support their discussion around the risks highlighted.

Part 2

A company is typically financed (or capitalised) 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 way a company is capitalised will often have a significant impact on the amount of profit it reports for tax purposes. Country tax rules typically allow a deduction for interest paid or payable in arriving at the tax measure of profit. The higher the level of debt in a company, and thus amount of interest it pays, the lower will be its taxable profit. For this reason, debt is often a more tax efficient method of finance than equity.

Thin capitalisation rules typically operate by means of one of two approaches:

a) determining a maximum amount of debt on which deductible interest payments are available; and
b) determining a maximum amount of interest that may be deducted by reference to the ratio of interest (paid or payable) to another variable.

Candidates may mention the "arm's length" approach: Under this approach, the maximum amount of allowable debt is the amount of debt that an independent lender would be willing to lend to the company i.e. the amount of debt that a borrower could borrow from an arm's length

lender. The arm's length approach typically considers the specific attributes of the company in determining its borrowing capacity (that is, the amount of debt that company would be able to obtain from independent lenders). The arm's length approach can also encompass a determination of the amount of debt that a borrower would have borrowed if the lender had been an independent enterprise acting at arm's length. This "would have" approach is discussed in more detail below.

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. Depending on specific country legislative approaches, transfer pricing rules may or may not apply to determine the amount of the loan.

Some countries and commentators take the view that transfer pricing rules that are in line with Article 9 of the OECD Model Tax Convention may be sufficient to disallow interest relating to debt in excess of an arm's length amount and thus can be used to enforce an "arm's length" thin capitalisation regime. However, in order to provide certainty and clarity, many countries typically introduce specific thin capitalisation provisions, even where they adopt a purely arm's length approach and have existing transfer pricing rules that apply the arm's length approach.

Question 6

Part 1

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

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.

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).

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

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

Once it is determined that an inter-group service has been rendered, there is a need to determine if the amount of the charge is in accordance with the arm's length principle. There direct charge methods and indirect charge methods.

In relation to low value-adding services, it is possible to apply a simplified approach (set out in D.1). Paragraph 7.45 includes details of low value-services with paragraphs 7.47 to 7.49 indicating activities which would not qualify for the simplified approach. D.2 sets out the simplified approach for law-value adding intra-group services including application of the benefits test, determination of cost pools and allocation.

Appropriate allocation keys depend on the facts and circumstances. In summary, charges for intra-group services should be that which would have been made and accepted between independent enterprises in comparable circumstances.

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. 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.

Part 2

Identifying the legal ownership of the intellectual property and the contractual arrangements is a critical step as part of the identification of intellectual property. This equally applies to identifying the functions, assets and risks of the parties to the arrangements.

Candidates may discuss the following models available to develop intangibles.

Contract research and development is an agreement between parties (associated or independent) in undertaking research and development activities/development with a view to creating or enhancing intangibles. It is typically a legal agreement/contract that articulates which activities are carried out by which party, which of the parties becomes the owner of the developed intangibles as a result of the contractor's activities, fees for the activities undertaken, record keeping, duration and (consequences of) termination and indemnification. The arm's length principle needs to be considered for contract research and development methodology and pricing (e.g. a cost plus).

Cost contribution arrangements – 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.

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.

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.

Candidates may discuss models available in relation to exploitation of intangibles. This may include the establishment of a principal within a structure/group that is the legal and economic owner of the intellectual property that licenses the use of the intellectual property to other entities to exploit through the sale of goods or provision of services whom pay a royalty in return. Other models may include variations to the structure whereby the legal or economic owner may be with other entities within the group.

Candidates may also make reference to the OECD TPG, Chapter VI.

Question 7

Part 1

Candidates are expected to explain the advantages and disadvantages from changes to transfer pricing documentation requirements from the perspective of both a tax administration and taxpayers.

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.

The preparation of detailed, contemporaneous documentation by a taxpayer, has a number of mutual 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.

In terms of disadvantages, 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 escalate to an audit. This is important given the limited resources of tax administration in order to be targeted.

Better candidates may briefly summarise the key changes to transfer pricing documentation requirements, specifically Country by Country reporting.

Part 2

Candidates may reference the OECD's work since BEPS Action 1 in relation to taxation of the digital economy. A key issue with digital platforms such as Amazon, Ebay, etc is the concept of profits not reported in the jurisdiction where the income is derived (customer sales) with no physical presence relative to value creation.

In the digital economy, value is not created in isolation by a company for the benefit of the customer but, in fact, is created as a consequence of the constant flow of information between the company and the customer. Value creation, therefore, is no longer a static eventuality at the end of a value chain but rather a result of dynamic interaction within a digital ecosystem of shops and networks. This therefore presents fundamental transfer pricing issues in terms of the FAR, value creation and attribution of profits.

In the digital economy, value is often created from a combination of algorithms, user data, sales functions and knowledge. For example, a user contributes to value creation by sharing his/her preferences (e.g. liking a page) on a social media forum. This data will later be used and monetised for targeted advertising. The profits are not necessarily taxed in the country of the user (and viewer of the advert), but rather in the country where the advertising algorithms has been developed, for example. This means that the user contribution to the profits is not taken into account when the company is taxed.

Better candidates may mention the OECD's two-pillar solution as well as the imposition by some jurisdictions previously, such as the UK, of a digital services tax. Essentially attempting to ensure that profits are taxed in a territory even in absence of a physical presence there, i.e. a digital presence. This reflects a link between where digital profits are made and where they are taxed.

Question 8

Part 1

The key articles relevant for transfer pricing based on the OECD MTC are:

Article 9 – Associated Enterprises

- Deals with transactions between associated enterprises which are not at arm's length or priced as independent parties would price. This Article allows a tax administration to make a transfer pricing adjustment.
- Addresses instances of double taxation and provides a mechanism for tax administrations to consult each other through delegated representatives called competent authorities.

Article 7 – Business Profits

- Deals with permanent establishments, including which jurisdiction has taxing rights in respect of the profits and how to attribute profits.
- Similar to Article 9, also addresses instances of double taxation and provides a mechanism for tax administrations to consult each other through delegated representatives called competent authorities.

Article 25 – Mutual Agreement Procedure

- Where a taxpayer is subject to or will likely be subject to double taxation (usually through a transfer pricing adjustment made by one tax administration) they can approach the tax administration (through a competent authority).
- The tax administrations should endeavour (no requirement) to seek to resolve any instances of double taxation.
- Any agreement reached between competent authorities is required to be implemented despite any domestic law limitations.
- If the tax administrations cannot reach a resolution within a two-year period after all relevant information is provided, the taxpayer has an option to request arbitration to seek resolution (subject to both jurisdictions having adopted).

Article 26 – Exchange of Information

- Mechanism for tax administrations (through competent authorities) to administer the Articles, as long as information is foreseeably relevant.
- Information exchanged shall be treated as secret and can only be on-disclosed in limited instances.

Candidates may also reference Articles of the United Nations Model Convention.

Part 2

Candidates may raise several valid points on the challenges posed by intangibles for tax administrations in the context of transfer pricing. A broad spectrum of issues may arise in practice, with a number listed below:

Identifying intangibles

- Intangible assets are increasingly important as a driver of profits within MNEs. Identification and valuation of intangibles is therefore an important part of the transfer pricing analysis by tax administrations. It is important for tax administrations to identify intangibles, establish the ownership of the intangibles and look at how they are valued, assess the contribution of the intangibles to value creation within the MNE group, and decide which group members contributed to the value of the intangible. The appropriate

transfer pricing method should then be established to allocate the profit between the related parties.

- The concept of an intangible is broader than just patents, copyrights, and trademarks, and could include additional categories such as available human capital, best practices, or non-contractual relations with the suppliers or with customers. These categories may have a value that should be compensated for at arm's length.

Valuing Intangibles

- The determination of an arm's length value for intangible assets is generally complex and is facing increasing scrutiny in transactions involving the use or transfer of intellectual property between associates. The valuation of IP and the resulting arm's length royalty or transfer price requires a correct delineation of the arm's length principle outlined in the OECD TPG. The valuation of the intangible should be examined carefully in line with global standards as outlined in the OECD TPG and U.N. Practical Manual on Transfer Pricing.
- Some tax authorities may take a view that the development, enhancement, maintenance, protection and exploitation (DEMPE) concept is fully determinative, not just for the allocation of income due to IP ownership, but also for the valuation and the economic ownership of the IP itself. The DEMPE concept was introduced in the OECD TPG in 2017.
- In recent cases involving the transfer of IP, a number of tax authorities of the jurisdiction purchasing the IP claim that the IP was already owned economically by the purchasing entity, and therefore suggested a low or zero IP value based on their own DEMPE assessment.
- In relation to the allocation on income from exploitation of the IP, the OECD TPG recognise that, while the legal owner of an IP may receive the proceeds from exploitation of the IP, other members of the legal owner's group may have performed functions, used assets, or assumed risks that are expected to contribute to the value of the IP. The members of the group performing such functions, using such assets, and assuming such risks must be compensated for their contributions under the arm's length principle. The allocation of profit or loss from exploitation of the IP is based on the location of functions and control over risk.

Marketing Intangibles

- Marketing intangibles such as trademarks, trade names, or customer lists can be created by marketing activities and increase the sales of a product or a service for an MNE. For example, the local distributor of an MNE may benefit from central marketing activities within the MNE group and may make a payment to an associate in relation to use of the brand. Tax authorities should have regard to any payments made by the local entity to the associate for the use of the brand and consider the relevance of that global brand in the local context. The relative value of marketing intangibles in relation to the overall performance of the local economy should be taken into consideration.

Cross-Border Intellectual Property Transactions

- Establishing the correct rate for royalties paid for the use of intellectual property held by a related party may be challenging, especially if suitable comparable transactions are not available. Cross-border payments for the use of intangibles are sometimes considered a method by which profits may be shifted between jurisdictions. The arm's length royalty rate also has implications for withholding tax which generally applies to intellectual property.

DEMPE risk control functions

- It is not common that MNE groups have all risk-controlling functions for economically significant risks relating to the DEMPE of IP employed by a single entity and based in one jurisdiction. Many MNE groups have DEMPE risk control functions divided between several entities in different jurisdictions due to a range of factors including: the impact of

historical mergers and acquisitions activities and internal processes around research and development (R&D) commercial exploitation.

- In cases where the IP development activity was outsourced to an associate under a contract R&D arrangement, the arm's length compensation for such contract R&D services must be established. The OECD TPG indicate that the functions performed by contract R&D providers, including any risk mitigation or DEMPE functions, should be appropriately compensated via a service arrangement (i.e. usually cost plus) and should not impact the valuation of the IP.
- While it may not be necessary for the IP owner to perform all DEMPE risk control activities itself for it to be recognised as the economic owner of the IP, it is essential that the IP owner undertakes meaningful risk control functions for the specific economically significant risks relating to the IP it owns, as well as having the financial capacity to bear financially significant risks.

Question 9

Part 1

In the event that a tax administration makes a transfer pricing adjustment following an audit, the taxpayer must approach a competent authority from the tax administration that made the adjustment or that of the other tax administration which has already taxed the income i.e. the other side to the transaction. Refer to Article 25 of the OECD MTC.

Historically, the primary challenge with Mutual Agreement Procedure (MAP) has been its inability to compel tax administrations through competent authorities to reach agreement in a timely fashion or at all. This has resulted in some MAP cases not being resolved efficiently, or in some cases ever. These concerns contributed to the advent of BEPS Action 14, which called for greater certainty and predictability by improving the effectiveness of MAP and raising the possibility of mandatory binding arbitration.

The OECD and the Inclusive Framework on BEPS Action 14 culminated in the inclusion of Part VI in the Multilateral Instrument (MLI). Jurisdictions may choose to incorporate Part VI into their existing Double Tax Agreements or Treaties where the other jurisdiction simultaneously chooses to incorporate Part VI into their DTA.

Under Article 19 of the MLI, a taxpayer can refer a MAP dispute to arbitration if the dispute has remained unresolved for two years (some countries have agreed to three years instead of two). Arbitration is triggered by the taxpayer (not the tax administration) making a request in writing to one of the competent authorities. However, the issue must not have been considered by a court or administrative tribunal in either of the jurisdictions. The two-year period applies from:

- The date on which both competent authorities notify the taxpayer that they have received enough information to undertake a substantive consideration of the MAP dispute; or
- If earlier, where neither competent authority requests further information, three months after the competent authority to which the request to commence MAP was made notified the other of the request; and
- Where either competent authority requests further information – three months after both competent authorities have received all requested information from the taxpayer.

The two-year period may be altered by agreement by the competent authorities or may be extended if the competent authorities agree that the taxpayer has failed to provide information in a timely manner. The two-year period may also temporarily stop running if MAP is suspended by agreement of the competent authorities or because a case dealing with the same issues is pending before a domestic court or tribunal.

If the taxpayer accepts the arbitration decision, the decision shall be binding on the jurisdictions and should be implemented despite any domestic time limitations.

Part 2

The OECD/G20 Inclusive Framework on BEPS adopted a Programme of Work to Develop a Consensus Solution to the Tax Challenges arising from the Digitalisation of the Economy in May 2019.

The Pillar One and Pillar Two proposals would introduce significant changes to the international tax rules, affecting global investment through their impacts on the incentives faced by MNEs and governments. Amount A of Pillar One involves the creation of a new taxing right and the reallocation to market jurisdictions of a share of residual profit determined at the MNE group level, based on a formulaic approach. Pillar Two addresses remaining BEPS challenges and is designed to ensure that large multinational businesses pay a minimum level of tax of 15% regardless of where they are headquartered or the jurisdictions they operate in.

In October 2021, 135 members of the OECD/G20 Inclusive Framework on BEPS agreed to Pillar Two. Pillar Two seeks to respond to continued concerns regarding profit shifting, harmful

tax competition, and ‘race-to-the-bottom’ on corporate tax rates. Pillar Two will likely have important implications for the use of tax incentives around the world.

Tax incentives are widely used policy tools in both developed and developing countries, predominately used to attract investment and influence its size, location or industry. Tax incentives regimes typically differ in design and can include tax holidays, exemptions and reduced rates, generous allowances and credits which can be often linked to specific research & development related activities.

Pillar Two places agreed limits on tax competition and should ease the pressures on jurisdictions to offer tax incentives. Where an in-scope MNE’s effective tax rate (ETR) in a jurisdiction falls below 15%, the MNE would potentially be subject to top-up taxes under the Global Anti-Base Erosion (GloBE) Rules. Pillar Two will reduce the incentive for MNE’s to engage in profit shifting and will support jurisdictions in achieving a better balance between using tax policy to attract investment and mobilising domestic revenues.

Jurisdictions will continue to be able to use the tax system to attract investment under the GloBE Rules, but the rules will discourage the use of damaging tax incentive policies. The GloBE Rules will impact the use of different tax incentives in different ways, with some incentives only being affected to a limited extent if at all. Where tax incentives are successful in attracting tangible investment and jobs, the rules will have a more limited impact. However, where tax incentives allow MNEs to generate substantial low-taxed profits in a jurisdiction without providing substantial tangible investment or jobs, the GloBE Rules will help protect the corporate tax base.

It is expected that jurisdictions which currently offer tax incentives to MNEs are likely preparing for Pillar Two, including through a thorough assessment of the tax incentives currently in place. The introduction of Pillar Two provides for jurisdictions to consider tax incentive reform. If such jurisdictions don’t implement Pillar Two and continue to offer incentives, this will likely result in foregone tax revenues, as other jurisdictions move to impose top-up taxes.

Jurisdictions will likely be considering the introduction of a qualified domestic minimum top-up tax (QDMT). The introduction of a QDMT can ensure that jurisdictions can tax low-taxed income arising domestically before that income is subject to top-up taxes imposed by other jurisdictions.

It is expected that jurisdictions should exercise caution when considering implementing new tax incentives or entering into new investment contracts in the period leading up to the implementation of Pillar Two, which is from 1 January 2024.

In 2022, the OECD released a report titled “Tax Incentives and the Global Minimum Corporate Tax: Reconsidering Tax Incentives after the GloBE Rules”. The observations from the OECD are that jurisdictions should examine which taxpayers are benefiting from different incentives, and how different taxpayers and tax incentives will be affected by the GloBE Rules, noting that:

- Tax incentives can still provide benefits for firms that are not in-scope of the GloBE Rules, such as domestic firms or subsidiaries of MNE groups with revenues below EUR 750 million.
- Firms with a greater amount of substance in a given jurisdiction will be less affected than others, as they will benefit from the substance-based income exclusion (SBIE) and will face a smaller increase in effective taxation as a result of the introduction of the GloBE Rules.
- Tax incentives that are better targeted are likely to be less affected by the GloBE Rules than incentives that are very broad, all else equal. Incentives that are narrowly targeted to certain categories of income or expenditure may be less affected due to the blending of MNEs’ income within a jurisdiction.
- Expenditure-based tax incentives that target payroll or tangible assets may be less affected than income-based tax incentives. Such provisions require expenditures that are part of the SBIE, which excludes a share of profits from top-up taxes based on the level of economic substance.

- Tax incentives that allow the faster recovery of the cost of tangible assets will be unaffected by the GloBE Rules. These include immediate expensing or accelerated depreciation for investment in tangible assets.
- The GloBE Rules follow financial accounting by treating cash grants and refundable tax credits as income, which means that these types of incentives are less likely to be affected. While these instruments may allow jurisdictions to continue to offer incentives to MNEs, jurisdictions should exercise caution due to their potentially significant fiscal impact.