

Answer-to-Question-_1_

Part 1

According to the OECD Transfer Pricing Guidelines 2017 (OECD TPG), in order to apply arm's length principle the following stages have to be performed:

- 1) Accurately delineate the transactions taking into considerations conditions and economically relevant circumstances (also referred to as comparability factors), and
- 2) comparison of conditions and economically relevant circumstances between controlled transaction accurately delineated and conditions and economically relevant circumstances of comparable transactions between unrelated parties.

We need to refer to Chapter 7 of the OECD TPG. It is mentioned that the following steps should be followed:

- 1) Determining whether intra-group services have been performed
- 2) Determining the arm's length charge

The following transactions within the GP Group have been identified:

GP Headco

1. Provision of R&D services to the Group's affiliates
2. Recipient of contract manufacturing services from GP Sub 1 and GP Sub 2
3. License from GP Sub 2
4. Recipient of products from GP Sub 1

GP Sub 1

1. Provision of contract manufacturing services to GP Headco
2. Sale of products to GP headco
3. License from GP Sub 2
4. Recipient of R&D services from GP Headco

GP Sub 2

1. Provision of contract manufacturing services to GP Headco
3. Provide license to GP Headco GP Sub 2
4. Recipient of R&D services from GP Headco

Part 2

According to the OECD Transfer Pricing Guidelines 2017 (OECD TPG), in order to apply arm's length principle the following stages have to be performed:

- 1) Accurately delineate the transactions taking into considerations conditions and economically relevant circumstances (also referred to as comparability factors), and
- 2) comparison of conditions and economically relevant circumstances between controlled transaction accurately delineated and conditions and economically relevant circumstances of comparable transactions between unrelated parties.

According to the OECD TPG, there are five comparability factors:

1. Contractual terms
2. Functional analysis
3. Characteristics of the property transferred and services provided
4. Economic circumstances
5. Business strategies.

Therefore, functional analysis is one of the key activities in order to apply arm's length principal. As part of the functional analysis, the functions performed, risks assumed and assets used by each entity of the GP Group have to be identified.

Additionally, it worth mentioning that the functional analysis summary can be performed on the entity-by-entity basis or by function. The summary presented below was prepared following the entity-by-entity approach.

Also, the risk assumed by the entities can be internal and external. Since external risks are not dependent on the entity, they have not been considered in this functional analysis.

GP Headco

Functions

1. Strategic management
2. R&D function
3. Financial management
4. Cash pooling

Risk

1. Financial risk
2. Market risk
3. Design intellectual property
4. R&D risks
5. Operational risk

Assets

1. Online apps (it is mentioned that sales are received from online apps, however, it is not clear who is the owner)
2. Routine tangible assets (e.g. office equipment)

3. Headcount (even though it is not mentioned, it is fair to assume that the entity has employees since it performs R&D activities)

The entity can be characterized as entrepreneur and provider of the R&D services.

GP Sub 1

Functions

1. Contract manufacturing
2. Sales
3. Cash pooling

Risk

1. Foreign exchange risk
2. Market risk
3. Operational risk
4. Stock
5. Inventory risk

Assets

1. Production equipment
2. Routine tangible assets (e.g. office equipment)
3. Headcount
4. Customer list

The entity can be characterized as contract manufacturer.

GP Sub 2

Functions

1. Contract manufacturing
3. Cash pooling

Risk

1. Operational risk
2. Stock
3. Inventory risk

Even though, the entity is the legal owner of the IP, it doesn't provide the DEMPE functions based on the provided information.

Assets

1. Production equipment
2. Routine tangible assets (e.g. office equipment)
3. Headcount

The entity can be characterized as contract manufacturer.

Part 3

According to the Chapter II of the OECD TPG, there are following methods:

Traditional transactional methods

1. Comparable Uncontrolled Price method (CUP)
2. Resale Price method (RPM)
3. Cost plus method (CPM)

Transactional profit method

4. Transactional Net Margin method (TNMM)

5. Profit Split method (PSM)

Up to 2010 OECD TPG had hierarchy of the TP methods, currently, there is no. However, among various jurisdictions, CUP is the most preferable TP method.

CUP

Method compares price charged for property or services transferred in a controlled transaction to the price charged for property and or services transferred in a comparable uncontrolled transaction.

This TP method can be applied to:

1. License provided by GP Sub 2 to GP Headco and GP Sub 1. The internal CUP is available since GP Sub 2 provides license also to independent party (i.e. Independent Co 1).
2. Provision of physical products by GP Sub 1 to GP Headco. The internal CUP is available since GP Sub 1 sells products (under assumption that the products characteristics are the same) also to independent party (i.e. Independent Co 1).
3. Contract manufacturing services provided by GP Sub 1 and GP Sub 2. The internal CUP is available since GP Headco receives the same services from Independent Co 1 which is independent party. However, the services should be reviewed and analysed whether the nature and extent are similar to the services provided by the associated enterprises.

RPM

This 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 is then reduced by an

appropriate gross margin in this price representing the amount out of which the reseller would seek to cover its selling and other operating expenses.

This method is not relevant for the Group.

CPM

This method begins with the cost 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.

This method can be selected to test the arm's length nature of the pricing applied to provision of R&D services by GP Headco to the Group's affiliates.

TNMM

It examines the net profit relative to an appropriate base.

This method can be the most optimal to test the arm's length nature of the pricing applied to provision of R&D services by GP Headco to the Group's affiliates since the CM is difficult to apply, in a practical matter, due to the accounting differences between tested party and comparables.

PSM

This method seeks to eliminate the effect on profits of special conditions made or imposed in a controlled transaction by determining the division of profits that independent enterprises would have expected to realise from engaging in the transaction.

PSM has two types:

- Contribution analysis
- Residual profit analysis

The PSM can be applied to GP Headco.

Answer-to-Question-_2_

Part 1

As part of the tax audit the following issues may be raised:

- 1) Since the contract manufacturing agreement were cancelled. It is important to understand whether new agreements have been concluded between GP Headco and GP Sub 1 and GP Sub 2. Additionally, the pricing applied to new transaction has to be defined and reviewed against the arm's length principal.
- 2) The new functional characterization of GP Sub 1 and GP Sub 2 have to reviewed from Chapter IX OECD TPG perspective. Since typically the centralized models (it seems that the GP Group has the centralized model)do not convert contract manufacturers into full fledged manufacturers. Therefore, the reasons for such restructuring have to be reviewed in detail.
- 3) The arm's length nature of the funds lent to GP Sub 1 and GP Sub 2 has to be reviewed from Chapter X OECD TPG perspective. It is important to understand what interest rate applied, where it is base rate or base rate with the margin or interest-free loan. In addition to this, tax authorities may challenge whether this is a loan or an equity injection.
- 4) Existence of the PE in the jurisdictions of GP Sub 1 and GP Sub 2.
- 5) In relation to the transfer of the legal ownership of new video game , the following should be considered taking into

account Chapter VI of the OECD TPG:

- How the value of the transferred intangible property has been defined?
- Is the transfer of the IP has been performed in line with the arm's length principal?
- Which entity will perform the DEMPE functions?

Additionally, the legal ownership was transferred to the entity located in the low tax jurisdiction which may raise questions from the tax authorities.

Part 2

In order to discuss the PE, it worth mentioning the main source: Article 5 of the OECD Model Tax Convention, Action 7 of the BEPS Action Plan, the OECD report on the Attribution of profits to PE and Article 7 of the OECD MTC.

According to the Article 5 of the OECD MTC, PE is the fixed place of the business through which the business of an enterprise is wholly or partly carried on. According to the Article 5 of the OECD MTC (there are differences to the United Nation MTC) the term PE includes the following:

- a place of management
- branch
- office
- factory
- workshop
- mine

There is also exception from the PE definition, if the entity performs propitiatory or auxiliary activities. In this case, this will not create a PE.

The following should be considered in relation to the case of the GP Group:

- It can be argued by the tax authorities that the GP Headco has a fixed place of business in Country B and Country C
- Whether the activities performed by the R&D staff of GP Headco can be considered as dependent agent since they conclude contracts on behalf of GP Holdco in Country B and Country C.
- It is important to understand the role of the sales staff from GP Sub 1 and GP Sub 2. Do they negotiate or conclude the contracts on behalf of GP Headco? Is the agreement concluded between GP Headco and its subsidiaries (GP Sub 1 and GP Sub 2) for the provision of the sales?
- The attribution of profits to Country B and Country C. In this case the authorized OECD approach consisting of two stages has to be performed.

Answer-to-Question-_4_

Part 1

We need to refer to Chapter 7 of the OECD TPG. It is mentioned that the following steps should be followed:

- 1) Determining whether intra-group services have been performed
- 2) Determining the arm's length charge

Step 1

As part of the first step. The benefit test should be performed. The key aim of the benefit test is to understand that if the activity is not one for which the independent enterprise would have been willing to pay or perform for itself, the activity should not be considered as an intra-group service under the arm's length principle.

Following the benefit test the following services can be considered as potential chargeable:

- Research and development
- Manufacturing
- Logistics
- Marketing
- After sales support services
- Human Resources ("HR")
- Information Technology ("IT")

The independent parties might perform these services in-house or

outsource them.

It is worth mentioning that such services as HR and IT can be considered as low-value adding services according to Chapter VII of the OECD TPG. Since these services are supportive in nature, they are not part of core business of the Group, the use of unique and valuable intangibles are not involved to perform these activities and parties do not assume significant risks during the provision of these services. In this case a simplified approach can be followed, i.e. a 5% mark up applied. Therefore, it is important to understand what pricing policy is applied by Furniture Corp.

Part 2

As it has been mentioned above as part of the first step defined in the OECD TPG, the benefit test should be performed. Once this is completed, an MNE Group should identify whether it performs any of the following activities:

1. Shareholder activities

- Cost relating to the juridical structure of the parent company
- Cost relating to the reporting requirements
- Cost of raising funds for the acquisition of its participants and cost relating to the parent company's investor relations
- Cost relating to compliance of the parent company
- Cost which are supportive to the corporate governance of the MNE as a whole

2. Duplication

No intra-group service should be found for activities undertaken by one group member merely duplicate a service that another group member is performing for itself, or that is being performed for such other group member by a third party.

3. Incidental benefits

It is when an intra-group service performed by a group member relates only to some group members but incidentally provides benefits to other group members.

Based on the above mentioned, it can be concluded that the following services should not be chargeable between members of the group:

- Finance (incorporating accounts receivable, tax and treasury). These services can be considered as shareholder activities. the further analysis should be performed.
- Procurement or outsourcing of manufacturing to third parties. This service can be considered as duplicative in nature since it is also outsourced to a third party.

Part 3

Once it is determined whether intra-group services have been performed, then the arm's length charge can be determined. According to Chapter VII of the OECD TPG the intra- group services can be charged using :

- 1) Direct-charge method or
- 2) Indirect-charge method (cost allocation or apportionment)

The direct-charge method is the most favourable since as per this method associated enterprise is charged for specific service directly. However, in practise it is difficult to apply this method. It can be easily applied, when the service provided not only to associated enterprise, but also to third parties.

Since the core business activity of Furniture Corp. is the

distribution of household furniture, we can assume that the following activities can use direct charge method:

- Logistics
- After sales services via a call centre

Regarding the other services, the indirect-charge method can be selected:

- costs for the manufacturing of the furniture
- number of produced items
- employees involved in the provision of the services/production

Answer-to-Question-_6_

Part 1

The Advance Pricing Agreement (APA) is prescribed by Chapter IV of the OECD TPG. The first jurisdiction where the APA has been introduced in the United States of America.

APA is the arrangement between taxpayer, one or more associated enterprises, and one or more tax authorities to determine in advance an appropriate set of criteria that satisfies all parties and can be used to determine the arm's length transfer price for the transaction covered by the APA over the duration of the agreement.

The OECD TPG prescribes the following types of the APAs:

- Unilateral (one taxpayer and respective tax authorities)
- Bilateral
- Multilateral

The unilateral APA is considered not so effective as other two types since it is involved only one jurisdiction, hence the double taxation issue may occur.

The following subjects can be covered under APA:

- selection of the TP method
- comparables
- selection method for the comparables
- comparability adjustment

- future event

The APA provides following benefits for the taxpayer and tax authorities:

- It provides certainty to an MNE Group on the appropriate pricing of the transaction
- Simplifies the compliance and reduce costs for the MNE Group
- Tax authorities can be more focused on the high risk taxpayers or transactions

The OECD TPG doesn't provide the term for the APA. However, typically APA is concluded between the MNE Group and tax authorities for 5 years.

Part 2

Taking into account the recent developments in the tax world, the Country-by-Country Reporting (CbCR) will provide jurisdiction with the better overview of the allocation of profits within the group and its substance.

The CbCR is one of the compliance obligation from three-tier documentation prescribed by the OECD in Chapter V of the OECD TPG and by Action 13 of the BEPS Action Plan, i.e. Local file, Master file and CbCR.

The CbCR should be prepared and filed by the Ultimate Parent Entity if the consolidated revenue of the Group in prior year was equal or exceeded EUR 750 million. The deadline for the CbCR filing is one year after the financial year end, e.g. the FY2020 CbCR will be filled by MNE Groups by 31 December 2021.

If the jurisdiction introduces the CbCR, the tax authorities will have access to such informations as :

- related party revenue
- unrelated party revenue
- total revenue
- income tax paid
- income tax accrued
- tangible assets
- accumulated earning
- number of employees

Apart of other general information (presented in Table 2 of the CbCR template) such as address, TIN, main business activity.

This financial information may help tax authorities to identify high risk indicators which are prescribed by the OECD CbCR risk assessment handbook.

It worth mentioning the recent development in this regard. The United Arab Emirates introduced the CbCR in 2019, even though there is no Corporate Income Tax in this jurisdictions.

Additionally, recently, i.e. on 1 December 2021, the EU Public CbCR directive has been published in the official gazette. This means that first public CbCR will be filed by the MNE Group in 2026. The Directive relates as to EU headquartered MNEs as to non-EU headquartered MNE that have Constituent Entities in the European Union.

Answer-to-Question-_7_

Part 1

Secret comparables is the term which is used for the comparables available to tax authorities. The tax authorities have access to the comparables which are not publicly available.

The OECD doesn't support jurisdictions to use the secret comparables, as it is not fair for the taxpayer. However, some jurisdictions as for instance China, can use secret comparables according to the domestic legislation.

The Transfer Pricing adjustment is determined based on the position in the range which is calculated from the financial information of accepted comparables. Taxpayer is allowed to use publicly available information and databases (such as Orbis, Amadeus, Oriana etc). According to the statements provided in the OECD TPG, it can be concluded that the obligation of the taxpayer is to accurately delineate the transaction and the compare condition and economically relevant circumstances of this transaction to the comparable transaction between independent parties. This means that the taxpayer is obliged to select appropriate TP method, identify comparables and accept appropriate. Then the taxpayer calculate the range based on the findings. However, in the case of secret comparables this cannot be done since the financial information on these comparables is not available to the taxpayer.

Part 2

First of all, it should be mentioned that according to the OECD TP Guidelines, the extreme results cannot be excluded merely because they are extreme. They can be excluded on the ground that they bring to light previously overlooked effects in comparability. However, there is no general rule whether the loss-making comparables should be excluded or included.

The extreme results can be as extreme profit or extreme loss.

The situation of the COVID-19 pandemic had dramatic impact to many MNE Groups. The major part of the MNE Groups made significant losses during the year of the pandemic, e.g. airplane companies since all the borders were closed and people couldn't travel. In this case the losses reflect the economic circumstances in the world and therefore, it has to be taken into consideration. According to the OECD TPG, there are five comparability factors (economically relevant circumstances):

1. Contractual terms
2. Functional analysis
3. Characteristics of the property transferred and services provided
4. Economic circumstances
5. Business strategies.

Therefore, losses represent economic circumstances and have to be taken into account in order to apply arm's length principle.

However, some of the MNEs were able to generate profit during pandemic due to the industry where they operate, e.g. packaging of the food. Since the purchases of food increased during the pandemic. In this case the loss doesn't reflect normal business condition, therefore, in this case, the loss making comparables can be excluded.

As a summary, it can be concluded that in order to decide whether the loss making comparables have to be excluded or included (in period affected by the COVID-19 pandemic), the taxpayer has to consider all comparability factors, including such factor as economic circumstances.

Part 3

Arm's length principal is one of the pillars of the transfer pricing and it is prescribed by Article 9 of the OECD Model Tax Convention. The arm's length principal is the principal that transfer prices between related parties should meet arm's length test.

It should be noted that not all jurisdiction agreed to adopt arm's length principal, as for instance Brazil.

When the custom duties are calculated, the valuation method is applied. However, the valuation method applied by the customs cannot be comparable to arm's length principal. The customs pricing is calculated based on the price received from related, unrelated and individuals. Therefore, customs do not take into account related party transactions.

Such countries as United States and Canada have issued guidance on the acceptability by customs authorities of transfer pricing valuations and adjustments.

The higher the value of the goods at importation, the greater the customs duty. However, the same approach doesn't work in the application of the arm's length principal.