THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

December 2024

MODULE 3.03 – TRANSFER PRICING OPTION

SUGGESTED SOLUTIONS

PART A

Question 1

Part 1

Candidates are required to accurately delineate the transactions between the associated enterprises of the ATS group.

- A loan provided by United Resorts LLC (Country A) to CWU (Crystal Waters Island) with 11.5% interest rate and monthly payments over a 20-year term. Therefore, interest payments made by CWU to United Resorts LLC.
- A loan provided by United Resorts LLC (Country A) to WSM (Country C) with 9% interest rate. Therefore, interest payments made by WSM to United Resorts LLC.
- CWU pays a royalty of 4.5% of gross sales to United Resorts LLC for use of the group trademark.
- WSM (Country C) pays a royalty of 2.5% of gross sales to United Resorts LLC for use of the group trademark.
- UMP (Country B) provides various services to CWU for which UMP is remunerated to the value of 2.5% of gross revenue and 10% of operating profit.
- UMP (Country B) provides various services to WSM for which UMP is remunerated to the value of 2.5% of gross revenue and 10% of operating profit.

Part 2

Reference is made to the OECD Transfer Pricing Guidelines (2022), Chapter II: Transfer Pricing Methods.

Part II of Chapter II of the OECD Transfer Pricing Guidelines (2022) lists the traditional transaction methods - Section B: Comparable uncontrolled price (CUP) 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.

A CUP method may be applied to the to the loan transactions delineated. This would include:

1) Benchmarking the loan provided by United Resorts LLC (Country A) to CWU (Crystal Waters Island) with the loan provided by United Resorts LLC (Country A) to WSM (Country C). The totality of the arrangement would need to be considered as well as the purpose of the loan and all terms and conditions having regard to the commercial and financial relations. This is potential internal CUP.

2) Benchmarking the loan provided by United Resorts LLC (Country A) to CWU (Crystal Waters Island) with any other external loans with either entity. Again, the totality of the arrangement would need to be considered as well as the purpose of the loan and all terms and conditions having regard to the commercial and financial relations. This is potential external CUP.

3) Benchmarking the royalty transaction between CWU and United Resorts LLC with the royalty transaction between WSM (Country C) and United Resorts LLC for the use of intellectual property. This would potentially be applied as an internal CUP.

4) Benchmarking the royalty transaction between CWU and United Resorts LLC with and external royalty arrangements. This would potentially be applied as an external CUP.

The comparability factors would need to considered in the potential application of this method. Reference is made to Section D of Chapter 1 of the OECD Transfer Pricing Guidelines (2022).

Part II of Chapter II of the OECD Transfer Pricing Guidelines (2022) lists the traditional transaction methods - Section D: Cost plus method.

Candidates may also describe considerations for the provision of services with reference to Chapter VII – Special considerations for intra-group services.

A cost plus method may be applied to:

1) The services provided by UMP (Country B) to CWU.
2) The services provided by WSM (Country C) to CWU.

The benefit of the services should be examined in terms of the value and complexity of them for the recipient. The cost base and relevant allocation key are important to consider as well as the margin attached for an arm's length remuneration with regard to each type and value of service involved.

Part III: Transactional profit methods - Section B: Transactional net margin method (TNMM) of the OECD Transfer Pricing Guidelines (2022):

- The TNMM examines the net profit relative to an appropriate base (eg. costs, sales, assets) that a taxpayer realises from a controlled transaction.

- Less affected by transactional differences than a CUP.

- Net profit indicators more tolerant to some functional differences between the controlled and uncontrolled transactions than gross profit margins.

A TNMM may be applied to the profitability of CWU and WSM. An appropriate net profit indicator could include an EBIT/Sales margin. The functions, assets and risks of these entities in the United Resorts Group would need to be analysed.

<u>Part 3</u>

In terms of issues that may be raised from a transfer pricing risk management perspective:

- The arm's length nature of all delineated transactions including:

  - Financing (loans)
  - Services provided/received
  - Royalty payments

- The totality of the financing arrangements need to be considered as the commerciality and broader implications for the United Resorts Group.

- The differences in corporate tax rates creates potential arbitrate and profit shifting from transfer pricing.

- Testing the nature and value of the services relative to remuneration through conducting functional interviews.

- The remuneration for the services provided in terms of the method selection and application – a return on sales plus a share of operating profit would be considered significant relative to a cost plus method being applied.

- Understanding the broader business model and value chain would be required, particularly with construction of large resorts being significant capital investments.

- The involvement of CWU in the construction of the hotels in the context of the global value chain and economic contribution relative to remuneration in the arrangement/project.

- Potential permanent establishments for the construction companies of the resorts if not registered in each jurisdiction.

Question 2

Part 1

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.

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.

Associated Entity within the ATS group	Functions	Assets	Risks	Characterisation
FastConnect HeadCo Ltd (Country A)	Intellectual property hub (DEMPE) Provision of services including technical, accounting, HR, procurement, supply chain management, and legal	Intellectual property Offices Staff	Intellectual property (DEMPE) risk Market risk	Intellectual property owner/hub Service provider
Fastconnect Sub 1 Ltd (Country B)	Provision of centralised connection services	Property, plant and equipment Warehouses Offices Staff	Market risk Inventory risk	Services provider
Fastconnect Sub 2 Ltd (Country C)	Provision of technical network services	Staff Offices Warehouses	Market risk Inventory risk	Services provider
Fastconnect Sub 3 Ltd (Country D)	Project management	Staff Offices	Market risk	Project manager

Part 2

The license fee paid by each of the subsidiaries to FastConnect HeadCo Ltd would need to be demonstrated to be at arm's length. The nature, value and complexity of the services would need to be examined and the most appropriate method selected. The license fee in this case is based on a percentage of the subsidiary's revenue. This may be challenged in terms of an alternative method being a cost plus.

The transaction between FastConnect Sub 1 Ltd and FastConnect Sub2 Ltd would need to be demonstrated to be at arm's length, ie. Centralised connection services. Again, the value and complexity of the services would need to be examined and the most appropriate method selected. The license fee in this case is based on a percentage of sales revenues from customers. This may be challenged in terms of an alternative method being a cost plus.

The technical network services provided by FastConnect Sub 2 Ltd to FastConnect Sub 1 would also need to be demonstrated to be at arm's length. Again, the value and complexity of the services would need to be examined and the most appropriate method selected. The remuneration in this case is a cost reimbursement plus a margin of 20%. This would need to be tested and compared with alternative methods. Also the difference in method for this transaction of services provided and the services provided by FastConnect HeadCo Ltd and FastConnect Sub1.

The functions, assets and risks of FastConnect Sub3 would need to be documented with regard to the project management for a new digital platform. The totality of the commercial and financial relations in relation to this project would need to be examined and the involvement of all other parties including the associated enterprises within the FastConnect telecommunications group. The cost contribution arrangement would also need to be analysed and demonstrated to be an arm's length arrangement.

In terms of intellectual property, aside from the contributions to DEMPE for members of the group to the project, the economic substance and contributions in relation to any intellectual property within the group relative to legal ownership would need to be documented. In addition, consideration would need to be given to any potential royalty payments for use of intellectual property.

For digital services provided/received between associated enterprises and independent customers, particularly in relation to the new project, documentation would need to consider the functions, assets and risks for each entity, the nature, value and complexity of the services. The location of customers and the booking of revenue and the location of the performance in relation to then digital services is important from a transfer pricing perspective also. and DEMPE (development, enhancement, maintenance, protection and exploitation) need to be fully examined. This includes the form and substance of the intangibles.

Analysis of intangibles should involve an investigation of the commercial and financial relations of the entities within the group to delineate the transactions. A functional analysis should be performed to identify which entities are creating intangibles or adding value through the value chain. Note OECD BEPS issues and Pillar 1.

PART B

Question 3

In considering whether any profits should be attributed to the jurisdiction of Neptunia, candidates should consider whether Neptunia has taxing rights. As Swickland and Neptunia are fictitious jurisdictions and no such Tax Convention between these jurisdictions exists, candidates should refer to the OECD Model Tax Convention on Income and Capital (2017).

Starr Group does not have an incorporated entity or subsidiary which is incorporated or resident in the jurisdiction of Neptunia.

Article 5 is relevant in considering whether a Permanent Establishment arises. Based on the facts available, Starr group does not satisfy the requirements as set out in paragraph 2 regarding having a place of management, branch, office, factory, workshop or mine in Neptunia. Further, Retro Ltd was responsible for installing the computer servers for the Government of Neptunia, so the €15 million sales and €300,000 profit from the installation will be attributed to this entity. Retro Ltd is an unrelated or independent party and is not considered an Associated Enterprise of Starr Group under Article 9.

Based on the facts, Starr Group is unlikely to habitually conclude contracts in Neptunia (paragraph 5).

Article 7 - Business Profits confirms that profits shall only arise if the enterprise carries out its business through a Permanent Establishment.

Under the OECD Model Tax Convention, in relation to the computer servers sold to the Government of Neptunia and the associated profit, this will be fully attributed to the jurisdiction of Swickland. The fact that employees of Starr Group, who are resident in another jurisdiction travelled to Neputinia for short periods to negotiate the contract is not sufficient to result in any taxing rights in Neptunia.

Generally, a Permanent Establishment requires a substantial physical presence in the jurisdiction concerned or where the non-resident carries on business in via a dependent agent. The changes arising from the OECD Base Erosion and Profit Shifting (BEPS) 2015 Action Items, particularly Action 7 on attribution to permanent establishments do extend to this case.

In responding, candidates should also refer to relevant Commentary in the OECD Model Tax Convention.

Question 4

Part 1

The chief financial officer (CFO) is proposing a business restructure. The 2022 OECD Transfer Pricing Guidelines at Chapter IX should be referenced by candidates, which addresses Transfer Pricing Aspects of Business Restructures.

Candidates may raise a number of key transfer pricing issues, such as:

- In applying Article 9 of the OECD Model Tax Convention, there is a requirement to determine if the conditions imposed in a business restructure differ from those that would be made between independent parties (para 9.9).

- The transactions should be accurately delineated that comprise the business restructure by identifying commercial or financial relations and the conditions attached to those relations that lead to the transfer of value (para 9.10).

    - Examine the economically relevant characteristics of the commercial or financial relations, and in particular the contractual terms (D.1.1).

    - Consider the functions performed by associated parties to the restructure, taking into account the assets used and risks assumed (D.1.1).

    - Economic circumstances of associated parties (D.1.4).

    - Business strategies, including analyse the business reasons for and expected benefits from the restructure, including the role of synergies and options realistically available (D.1.5).

- Assuming the business restructure proceeds, contemporaneous documentation should be prepared addressing the decisions and intentions regarding the business restructure, especially decisions to assume or transfer significant risks and document the evaluation of potential profit (Part B.4).

- The arm's length principle does not require compensation for a mere decrease in the expectation of an entity's future profits (relevant for Germany and Japan). However, where something is of value or terminated, independent partitions would likely provide appropriate compensation (Part D.1).

- Transfers of intangibles raise challenging questions both regarding the identification of intangibles transferred and their valuation. A number of factors such as the amount, duration and riskiness of expected benefits and natures of intangibles should be considered (Part E.2).

- There is a need to determine the arm's length price on the $200 million loan between United States to Brazil.

- At face value (and based on limited facts), there appears to be commercial rationale to undertake the restructure from a holistic perspective as it would result in $50 million cost savings or synergies for the group. It is noted that some of these savings are tax related.

- Some candidates may undertake a functional analysis (setting out functions, assets, risks and characterisation pre and post restructure) of the key associated enterprises.

Part 2

United States

- Discontinue manufacturing operations with sale of plant and equipment – uncertain of whether a profit or loss will arise based on information provided.

- Providing $200 million in funds to Brazil at an interest rate which is unlikely to be arm's length (proposal is funds sourced from the market and a discount of 1%). The loan should be appropriately benchmarked with an arm's length rate of interest applied (likely to be at least the cost of funds which the US based entity sourced from third party). Candidates should refer to Chapter X – Transfer Pricing Aspects of Financial Transactions which provides guidance.

- Will incur significant redundancy costs from cessation of manufacturing operations.

- Potentially will benefit from restructure from a financial perspective as based on facts keep ownership of intellectual property (Brazil will be a service provider for the United States and remunerated on cost plus 5%).
- Based on facts, other than loan unlikely to be material potential concerns.

Germany and Japan

- Discontinue manufacturing operations with sale of plant and equipment.
- Will incur significant redundancy costs.
- Loss of profits from discontinuation of manufacturing (9% margins currently).
- Potentially should be compensated for discontinuation of manufacturing and redundancy costs.
- No change to distribution arrangements or margin.
- Tax administrations potentially may be more concerned as a result of restructure and may expect that compensation should be paid (however, further information and analysis would be required). This will depend on whether an independent party would expect such compensation.

Brazil

- Should undertake benchmarking to ensure proposed margin for contract manufacturing (cost plus 5%) is appropriate.
- Should ensure that cost base includes all costs and financing has been considered as taking on considerable debt.
- Should benchmark loan (refer to Chapter X).

Distributors

Appears to be no change to arrangements – should be benchmarked and arm's length (i.e. just because no change it doesn't mean arm's length).

Other

Uncertain who prepares technical documentation for Brazil and if a country other than the United States prepares, this would likely be compensated.

PART C

Question 5

Part 1

Multinational groups can potentially adopt a number of strategies to minimise the risk of a transfer pricing disputes arising with tax administrations:

- Prepare comprehensive contemporaneous documentation, which should be updated each year.
- Ensure the arm's length principle is applied correctly to transactions between associated enterprises.
- Enter into an Advance Pricing Arrangements (APA) with tax administrations in relation to where they undertake material business between associated enterprises (preference is Bilateral if there is a treaty).
- Prioritise undertaking business in jurisdictions have tax treaties or conventions with the ultimate parent entity
- Engage the professional services of an experienced transfer pricing advisor or expert.
- Build a close relationship with tax administrations, including seeking rulings or advice where enter into transactions which may be perceived as risky.
- Prepare corporate governance documentation, including requesting board of directors approval for material decisions which are high risk from tax perspective.
- Participate in the OECD's International Compliance and Assurance Programme (ICAP) which is a voluntary risk assessment and assurance programme to facilitate open and co-operative multilateral engagement between MNE groups and tax administrations in relation transfer pricing.
- Candidates may refer to Chapter IV of OECD Transfer Pricing Guidelines addresses Administrative approaches to avoiding and resolving transfer pricing disputes.

Part 2

Candidates should briefly explain country by country reporting (CbCR), but are expected to evaluate if the measure has been successful from the perspective of tax administrations.

CbCR resulted from BEPS Action 13, which was revised guidance on transfer pricing documentation, including the template. The aim was to enhance transparency while taking into consideration compliance costs for MNE groups. Action 13 Report recommended that CbCR take place from periods commencing after 1 January 2016.

The requirement to file a CbCR applies to the ultimate parent entity (UPE) of a group, where the annual consolidated group revenue is at least EUR 750 million. The UPE is required to file a CbCR with its local tax administration within 12 months of its fiscal year reporting period. Such reports are then exchanged with other jurisdictions under bilateral treaties, multilateral treaties or TIEAS.

It is arguable whether CbCR has been fully successful, but on balance, the measure has been generally seen as successful, with some of the following benefits having arisen:

- Standard documentation automatically provided by an MNE group making it easier for tax administrations to identify potential transfer pricing risks.
- Enable tax administrations to carry out a risk assessment by accessing better quality documentation in a more timely manner and without a tax administration requiring a review, audit/examination or related activity from the tax administration to source the information.
- Encouraged MNE groups to be more transparent with factual information regarding business operations, profitability in jurisdictions and their value chain.
- Possibility of resulting in more Advance Pricing Arrangements and Mutual Agreement Procedures with better quality information.

- Tax administrations had to invest in infrastructure to accept CbCR and accept exchanges with other tax administrations.

- Tax administrations had to build capability in understanding and making use of CbCR information.

Question 6

Part 1

Chapter IV of the OECD Transfer Pricing Guidelines covers Administrative approaches to avoiding and resolving transfer pricing disputes, addressing Safe Harbours at E.1. Paragraph 4.102 states that a safe harbour in a transfer pricing regime is a provision that applies to a defined category of taxpayers or transactions and that relieves eligible taxpayers from certain obligations otherwise imposed by a country's general transfer pricing rules.

Candidates may reference a number of possible examples of tax administrations which have implemented a transfer pricing safe harbour. One such example is:

- Australian Taxation Office's (ATO) Practical Compliance Guideline PCG 2017/2 Simplified transfer pricing record-keeping options.

- Paragraph 12 confirms that if taxpayers are eligible to apply the PCG, the ATO will generally not allocate compliance resources to review the covered transactions or arrangements specified for transfer pricing purposes.

- To be eligible, criteria applies including turnover of the economic group being under $50 million, not making sustained losses, not undertaken a restructure, do not have dealings with associates involving royalties over certain materiality, do not generate specified service related party dealings more than 15%, are not a distributor, etc.

Part 2

Candidates may identify a number of valid considerations and challenges. For example:

- Complexity of transfer pricing – a significant challenge is tax compliance. There are varying degrees of tax regulations/legislation across countries. In recent years there has been an increased focused on transfer pricing by tax administrations with increased globalisation and focus on multinationals paying the correct amount of tax following the OECD's work on Base Erosion and Profit Shifting (BEPS). The transfer pricing legislation and requirements vary in each country and this can be complex.

- Obtaining accurate and reliable data for comparability purposes or benchmarking can be challenging. This is especially the case with complex transactions involving intellectual property or unique business models. Without reliable data, comparability analysis may be compromised. Potential comparable companies have tended to reduce over the years with mergers and acquisitions and globalisation. Different transfer pricing methods may require different data. Further, comparability adjustments may need to be undertaken for comparability factors such as geographic differences for example.

- Depending on legislation requirements or regulation, existence of transfer pricing documentation may shift the burden of proof from a legal perspective (and from potential application of penalties)

- Tax administrations will be able to access country by country reports and potentially made aware if profitability margins and transfer pricing methodologies vary amongst countries in which the multinational operates

- Transfer pricing is generally an inexact science and is multifaceted with numerous transactions, associated entities, currencies methodologies and data. This complexity can pose challenges for multinationals and usually requires expertise and the engagement of external resources which comes at a cost.

- Transfer pricing can influence the motivation of senior staff and employees within a multinational group. For example, there may be motivation to shift profit between operating units or associated enterprises which provide incentives.

Question 7

Part 1

Pillar One has two components:

- Amount A is proposed to apply to the around the 100 largest and most profitable multinational groups. Broadly, it applies to multinational groups with over EUR 20 billion in global income who also make a profit more than 10%. It reallocates 25% of profit to market jurisdictions in which the multinational satisfies the quantitative nexus test, subject to adjustments under the marketing and distribution safe harbour.

- Amount B is not subject to a revenue threshold and is potentially applicable to more multinational groups than Amount A and Pillar Two global minimum tax. Amount B is planned to be incorporated into the OECD Transfer Pricing Guidelines. Jurisdictions can elect whether they adopt Amount B for in scope transactions, starting on or after 1 January 2025. Amount B would apply to buy-sell marketing and distribution transactions where goods are purchased from associated enterprises for wholesale distribution to unrelated parties. It also applies to sales agency and commissionaire transactions. A pricing matrix of arm's length results (based on return on sales) applies based on a global data set of companies in baseline marketing and distribution activities (drawn on a benchmarking study). The range is baed on three industry groups and five categories of operating asset/expense intensities. The arm's length results vary from 1.5% to 5.5% return on sales. Documentation requirements under Amount B will be based on existing OECD requirements in Chapter V of the OECD Transfer Pricing Guidelines. When a taxpayer seeks to apply Amount B for the first time, this should be documented in the CbCR local file.

Pillar Two global anti-base erosion (GloBE) provides for a co-ordinated system of tax that imposes top-up tax on profits arising in a jurisdiction whenever the effective tax rate is less than 15%, determined on a jurisdiction basis. The rules are intended to be implemented as part of a common approach through domestic legislation. The measure applies to consistent entities that are members of a multinational group which have annual revenue exceeding EUR 750 million in the consolidated financial statements of the ultimate parent entity. Broadly, to be in scope the multinational group must have at least one entity or permanent establishment in a jurisdiction that isn't the same country as the UPE. The UPE's annual revenue must meet the threshold in at least 2 of the 4 fiscal years to be in scope. Certain entities are excluded including government entities, international organisations, non-profit organisations and pension funds, as well as UPEs which are either an investment fund or a real estate investment fund. The measure applies from 1 January 2024 for the income inclusion rule, with undertaxed profits rule starting from 1 January 2025. The OECD also has 4 safe harbours which taxpayers can elect to apply if they are eligible.

Arguably Pillar One, Amount B is more of a game changer as this will over-ride transfer pricing (if taxpayers are eligible). Further, this will likely provide increased certainty for tax administrations and multinational groups and reduce compliance costs. Amount B potentially applies to more taxpayers than Amount A and Pillar Two, but there is still a level of uncertainty whether it will proceed ad if so, which countries would adopt (subject to it proceeding) as each jurisdiction will have the discretion..

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.

Part 2

In relation to Pillar Two global minimum tax and domestic minimum tax, in order to be implemented, there is a requirement for each jurisdiction to legislate consistently with the GloBE rules under the common approach. This means that even if some countries don't implement the measure, they agree to accept the application of the rules by other jurisdictions. Jurisdictions can elect to apply the measure in full, or some elements of it. For example, a jurisdiction can apply domestic minimum tax, but not GloBE, which comprises income inclusion rule and undertaxed profits rule. Further, jurisdictions can elect to delay implementation, as some countries have announced such as Hong Kong and Singapore, for example.

Therefore, to be effective there is no requirement for all jurisdictions to implement. The GloBE rules are designed to ensure that multinational groups pay a minimum level of tax on the income arising in each jurisdiction where they operate. Jurisdictions have primary rights by having the option to implement a domestic minimum tax, by ensuring they impose top-up tax over any low taxed profits in their jurisdiction. This ensures that countries can collect revenue that would otherwise have been collected by another country's global minimum tax.

Income Inclusion Rule (IIR) allows jurisdictions to apply a top-up tax on multinational parent entities if the group's effective tax rate in another jurisdiction is below 15%. Undertaxed Profits Rule (UTPR) acts as a backstop rule, allowing jurisdictions to apply a top-up tax on constituent entities if the group's effective tax rate is below 15% and the profit is not brought into charge under the IIR. UTPR applies from 1 January 2025, but IIR and domestic minimum tax can apply from 1 January 2024.

The measure is designed to prevent a "race to the bottom" on corporate tax rates.

In summary, if certain countries do not implement the measure, they may forgo taxing rights and another jurisdiction may tax income which is taxed at a rate of less than 15% (or not consistent with the GloBE rules).

Question 8

Part 1

A transfer pricing risk assessment can be viewed from both the tax administration and taxpayer's perspective. For taxpayers, this process is generally managed either in-house and/or with advisors. Transfer pricing documentation is vital in identifying and managing transfer pricing risk and also for defence for a risk review or audit by a tax administration to demonstrate compliance with the arm's length principle. For a tax administration, a risk review may be conducted prior to commencement of an audit (if a higher level of risk is ascertained).

Some considerations that may lead to higher levels of risk during assessments may include:

- Materiality of dealings between associated enterprises.
- Business restructuring.
- Intangible assets utilised by group companies but no royalty paid.
- Cost sharing with no foreseeable benefit.
- Companies involved in transactions that might be overlooked.
- Companies making losses over a number of years.
- Sustained losses by local entities, but (overall) profits in the group.
- Margins suddenly decrease with no rationale.
- Companies with overseas subsidiaries with start-up losses.
- No formal agreement for services or finance provision with no recharge of costs.
- Debt levels, intra-group loans and guarantees that appear "un-commercial".
- Trading debtor balances – intercompany, long term, interest free.
- Dormant companies with intercompany creditors and net assets/investments.
- Group members who have acquired, created or enhanced an asset that is used by other group members, perhaps by incurring expenditure on research and development leading to the creation or enhancement of intellectual property.
- Significant group reorganisations involving business transfers overseas. • Transactions with low or no tax corporate tax rates and tax incentives.

Part 2

The practical 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, including at the operational levels.

An organisation chart would be requested to understand the structure and global value chain. From there, position description of potential interviewees would be requested before confirming interviews to be conducted. Interviews can be held in groups for operational staff across various functional areas of the organisation. Consideration needs to be given to interviewing both local staff in the jurisdiction and offshore associated enterprises.

During interviews, information relevant to functions assets and risks as well as specific roles and interactions with associated enterprises and independent parties. Decision making and approvals of functions are important as well as management of risk.

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.

Candidates may refer to the OECD TPG, Chapter X - Transfer pricing aspects of financial transactions and highlight areas noted including:

- 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.
- Thin capitalisation.

Case law may also be noted and discussed.

Part 2

Many jurisdictions have domestic law containing thin capitalisation provisions. The transfer pricing provisions are applied before the thin capitalisation provisions in determining the deduction allowable for the pricing of debt. The transfer pricing provisions, and the thin capitalisation rules have different functions.

The function of the transfer pricing provisions is to ensure that tax administrations can counter non-arm's length transfer pricing or international profit shifting arrangements. They provide a mechanism by which tax administrations adopt the accepted arm's length principle for taxation purposes to the ensure that conditions which would have existed between independent parties dealing at arm's length (or independently) with each other under comparable circumstances.

Under the thin capitalisation rules, the amount of debt used to fund the operations of certain entities limited. The rules generally disallow a deduction for a portion of specified expenses an entity incurs in relation to its debt finance, its debt deductions. The rules apply when the entity's debt-to-equity ratio exceeds certain limits. Provisions of tax treaties (or the OECD MTC), notably the Business Profits Article and the Associated Enterprises Article, contemplate adjustments to profits to reflect the outcome that would be achieved if cross-border dealings had been conducted in accordance with the arm's length principle.