

THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

Specimen Examination Paper

SUGGESTED SOLUTIONS

PAPER III

PRINCIPLES OF CORPORATE AND INTERNATIONAL TAXATION

F - TRANSFER PRICING OPTION

Suggested Solutions

The Fashionclothes Group

QUESTION 1

Functional analysis

In the table below, examples of further questions to be asked before a transfer pricing solution can be drawn are shown with “?”: this list is not exhaustive.

	The Fashionclothes Cie	The Polishdistri Company	Fashionclothes Manuf. Ltd
Functions	Designs clothes Manufactures Distributes (Austrian market) Others, e.g. promotion, marketing? Finance?	-- Distributes Fashionclothes products in Poland (buys and sells) Others, e.g. promotion, marketing?	-- Manufactures Fashionclothes products in India (contract manufacturer) -- Others ?
Assets	<u>Intangible assets:</u> -- Designs, models -- Know-how, efficient supply chain (to renew the catalogue every 3 weeks) -- Others: Trademark, logo, brand name? <u>Tangible assets:</u> -- Manufacturing equipment -- Inventories -- Retail points in Austria -- Others?	<u>Intangible assets:</u> -- Distribution / marketing knowhow in Poland -- Trademark, logo, brand name? <u>Tangible assets:</u> -- Inventories (but unsold inventory is sent back to the Fashionclothes Cie) -- 12 well located retail points	<u>Intangible assets:</u> -- Manufacturing know-how? <u>Tangible assets:</u> -- Manufacturing equipment -- Inventories?
Risks	Market risk (risk that customers don't buy) Inventory obsolescence risk (i.e. risk that inventory be unsold at the end of the 3 week period. This can be inventory for the Austrian market or inventory that has been transferred to the Polish distributor and should be bought back by The Fashionclothes Cie in case it is not sold by the latter) Others: Credit risk? Foreign exchange risk?	Market risk (risk that customers don't buy) Others: Credit risk? Foreign exchange risk?	Quality and timeliness of manufacturing process Inventory? (raw materials / finished products) Others: Foreign exchange risk?

Controlled transactions

- **Transaction 1:** After the acquisition of The Polishdistri Company: Sale of finished products by The Fashionclothes Cie to The Polishdistri Company and buy-back by The Fashionclothes Cie of unsold inventory from The Polishdistri Company. The products sold by The Fashionclothes Cie to The Polishdistri Company and bought back are products manufactured either in Austria by The Fashionclothes Cie or in India by Fashionclothes Manuf. Ltd.
- **Transaction 2:** Manufacturing by Fashionclothes Manuf. Ltd for The Fashionclothes Cie. We don't know whether Fashionclothes Manuf. Ltd takes title of the inventory: it is possible that it manufactures and sells the finished products to The Fashionclothes Cie under a contract manufacturing or similar agreement; or that The Fashionclothes Cie is the owner of the raw materials and finished products manufactured by Fashionclothes Manuf. Ltd, with the latter charging a manufacturing fee to the former under a toll manufacturing or similar agreement.

Uncontrolled transactions

- To be considered in the comparability analysis of **Transaction 1:** (i) sales of finished products by The Fashionclothes Cie to The Polishdistri Company before the acquisition of the latter by the former; (ii) sales of finished products by The Fashionclothes Cie to other uncontrolled distributors, if any; (iii) sales of products by the Fashionclothes Cie to Austrian customers (iv) purchases of finished products by The Polishdistri Company from independent suppliers, if any; (v) sales transactions between other suppliers of clothes and independent distributors.
- To be considered in the comparability analysis of **Transaction 2:** (i) Manufacturing by Fashionclothes Manuf. Ltd for independent customers, if any; (ii) Manufacturing by independent manufacturers for The Fashionclothes Cie, if any; (iii) Manufacturing by other manufacturers for independent clothes companies.

QUESTION 2

1. The five comparability factors are:

- Characteristics of products or services;
- Functional analysis (i.e. functions performed, assets used and risks assumed);
- Contractual terms;
- Economic circumstances;
- Business strategies.

Sales of products by the Fashionclothes Cie to the Polishdistri Company:

2. We try to apply the CUP method (Comparable Uncontrolled Price) to this transaction, i.e. to compare the price at which the Fashionclothes Cie sells products to the Polishdistri Company with the price in a comparable sale between independent parties.

We have information on the sales of products by the Fashionclothes Cie to the Polishdistri Company in 2008. These were uncontrolled sales and the functional analysis of the parties was the same in 2008 as in 2009, as far as we know. However, they were sales of different products (the catalogue is renewed every 3 weeks). These differences in product characteristics mean that it is not possible to compare the price of the products sold by the Fashionclothes Cie to the Polishdistri Company in 2009 with the price at which they were sold in 2008 (it does not seem possible to make a reasonably reliable adjustment to eliminate the differences between different models of clothes). So we can't use these sales as a CUP.

We also have information on sales of products by the Fashionclothes Cie to Austrian customers. These are likely to be sales of the same products as the ones sold to the Polishdistri Company during the same period of time (i.e. the first comparability factor, “product characteristics”, is likely to be satisfied). However, in terms of functional analysis, sales to Austrian customers (end users) cannot be compared with sales to the Polish distributor. Again, it does not seem possible to determine a comparability adjustment to eliminate the differences in functions, assets and risks involved in these two transactions.

Conclusion: there is no CUP on the basis of information that is available to us.

3. The tested party should be the less complex party to the transaction, i.e. the Polish distributor. In the absence of a CUP, we will suggest a resale price method (or a TNMM “net margin on sales”). The gross (or net) margin earned by the Polishdistri Company from its distribution of Fashionclothes products could be compared with the gross (or net) margin earned by a comparable uncontrolled distributor. If the economic circumstances are stable, it could be compared with the gross (or net) margin earned by the Polishdistri Company from its distribution of Fashionclothes products until 2008, i.e. at a time when these two companies were not associated. In addition or alternatively, the gross (or net margin) earned by comparable independent clothes distributors in Poland could be used as a benchmark.

QUESTION 3 - Manufacturing of products by Fashionclothes Manuf. Ltd for its parent company the Fashionclothes Cie

1 - The tested party should be the less complex party to the transaction, i.e. the Indian manufacturing company.

Assuming there is no CUP (i.e. the same products are not manufactured by an independent manufacturer), we will suggest a cost plus method (or a TNMM “net margin on costs” or “net margin on assets”). The mark-up on costs (or net margin) earned by Fashionclothes Manuf. Ltd from its manufacturing of Fashionclothes products could be compared with the mark-up on costs (or net margin) earned by comparable uncontrolled manufacturers – presumably independent Indian manufacturers of clothes.

2 - Location savings can be defined as the net savings that a multinational enterprise realises as a result of relocating from a high-cost to a low-cost jurisdiction: location savings = savings minus relocation costs.

Typically, savings are realised in relation to labour costs, real estate costs, raw material costs, etc.

Relocation costs can include higher transportation costs (e.g. where manufacturing is relocated to a location that is more distant from the market than the original manufacturing location); infrastructure costs, training costs, lower efficiency, etc. Lower tax rates are sometimes part of the location savings.

3 - From a transfer pricing perspective, in order to determine whether location savings would be attributed to the Fashionclothes Manuf. Ltd at arm’s length, one should determine the conditions that would be agreed between independent parties in comparable circumstances. This is likely to depend on the functions, assets and risks of the Fashionclothes Manuf. Ltd. In particular, if the Fashionclothes Manuf. Ltd. is performing low value-added manufacturing functions in a highly competitive environment, does not contribute any significant, unique intangible and does not assume any significant risk, it is unlikely to be attributed more than a routine remuneration for its manufacturing functions. On the other hand, if the Fashionclothes Manuf. Ltd. develops valuable, unique intangibles (e.g. unique manufacturing know-how, designing skills, unique quality, etc.) its bargaining position would be enhanced and it could benefit from part of the location savings through for instance a higher mark-up on costs (or a higher net margin). Depending on the facts and circumstances of the case, this could be done as a residual profit split.

QUESTION 4

Where two or more tax administrations take different positions in determining arm's length conditions, double taxation may occur. Double taxation means the inclusion of the same income in the tax base by more than one tax administration, when either the income is in the hands of different taxpayers (economic double taxation, for associated enterprises) or the income is in the hands of the same juridical entity (juridical double taxation, for permanent establishments). The double inclusion of income in the tax base of more than one jurisdiction does not always mean that the income will actually be taxed twice (as there can be loss situations for example).

The main treaty mechanisms available to eliminate double taxation that may result from a transfer pricing adjustment are:

- The correlative adjustment (Article 9(2) of the Model Tax Convention). Under Article 9(2), "where a Contracting State includes in the profits of an enterprise of that State – and taxes accordingly – profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits." In other words, if the second State agrees that the primary adjustment made by the first State is arm's length, then the first State shall make a corresponding downward adjustment to eliminate double taxation.
- The mutual agreement procedure, including its arbitration phase where available (Article 25 of the Model Tax Convention). Paragraphs 1-2 of Article 25 establish a mutual agreement procedure for resolving difficulties arising out of the application of the Convention, including economic double taxation that may result from a transfer pricing adjustment. Under these paragraphs, the competent authorities are under the duty to use their best endeavours, not to achieve a result. Paragraph 5 of Article 25 establishes a mechanism that will allow an agreement to be reached even if there are issues on which the competent authorities have been unable to reach agreement through negotiations. It provides that, in the cases where the competent authorities are unable to reach an agreement within two years, the unresolved issues will, at the request of the person who presented the case, be solved through an arbitration process. This arbitration process is an extension of the mutual agreement procedure. Paragraph 5 of Article 25 was introduced in the 2008 update of the Model Tax Convention. Recently, arbitration clauses have been adopted inter alia in the U.S. – Belgium, U.S. – Canada, U.S. – France and U.S. – Germany treaties, as well as in the treaties concluded between France and the United Kingdom, and between the Netherlands and the United Kingdom.
- For intra-EU flows, the EU Arbitration Convention (Convention 90/436/EEC on the elimination of double taxation in connection with the adjustment of profits of associated enterprises, 23 July 1990) is available to eliminate economic or juridical double taxation:
 - It applies where a transfer pricing adjustment is made by a tax authority in accordance with the arm's length principle to transactions between associated enterprises or to the attribution of profits to a permanent establishment.
 - It provides that, if the competent authorities concerned fail to reach an agreement that eliminates the double taxation within two years of the date on which the case was first submitted in mutual agreement procedure to one of the competent authorities, they shall set up an advisory commission charged with delivering its opinion on the elimination of the double taxation in question.

- The advisory commission shall deliver its opinion not more than six months from the date on which the matter was referred to.
- The advisory commission must base its opinion on the arm's length principle.
- The competent authority of a Contracting State shall not be obliged to initiate the mutual agreement procedure or to set up the advisory commission where legal or administrative proceedings have resulted in a final ruling that by actions giving rise to an adjustment of transfers of profits one of the enterprises concerned is liable to a serious penalty.

QUESTION 5

The July 2008 and July 2010 Council Recommendations give to the Report on the Attribution of Profits to PEs a similar status for attributing profits to PEs under Article 7 of the Model Tax Convention as the status of the TP Guidelines for applying the arm's length to associated enterprises under Article 9.

Under the AOA, the profits to be attributed to a PE are the profits that the PE would have earned at arm's length, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.

Profits may therefore be attributed to a PE even though the enterprise as a whole has never made profits. Conversely, Article 7 may result in no profits being attributed to a permanent establishment even though the enterprise as a whole has made profits.

The AOA is a two-step approach. Under the first step of the AOA, the PE is hypothesized as a separate and independent enterprise from the rest of the enterprise to which it belongs. In the second step of the AOA, the profits of the PE are determined by applying by analogy the arm's length principle to dealings between the PE and the rest of the enterprise.

The first step of the AOA has no equivalent under Article 9. In order to hypothesize a PE as a separate and independent enterprise from the rest of the enterprise to which it belongs, a factual and functional analysis of the PE is to be performed. It leads to the identification of the functions performed the PE and to the allocation to the PE of assets, free capital (and debt) and risks. In an Article 9 context, the balance sheet of the associated enterprises and the legal contracts entered by the associated enterprises with third parties and between them will serve as the starting point for the functional analysis – although a legal contract will only be respected to the extent that the behaviour of the parties corresponds to the contractual terms and that the contract has economic substance. In an Article 7 context, there are no legally binding contracts between a PE and the rest of the enterprise to which it belongs. Capital, assets and risks are those of the legal entity as a whole and specific criteria are described in the AOA to allocate them to a PE or head office. Reference is made in the AOA to the “significant people functions relevant to the ownership of assets” and to the “significant people functions relevant to the assumption of risk”. Methods to allocate free capital to a PE are described in the Report on the Attribution of Profits to PEs. Criteria are described for “dealings” between a PE and the rest of the enterprise to be recognised.

The second step of the AOA has greater similarities with the application of the arm's length principle to transactions between associated enterprises. When applying the second step of the AOA, recognised dealings are regarded as the equivalent, in the context of a single entity, of transactions between associated enterprises.

QUESTION 6

Main issues to be discussed in relation to the deductibility of interest paid by Taxpayer?

- Is the interest rate excessive?
 - The arm's length principle may assist in the determination of an arm's length interest rate in view of the conditions of the loan (including the amount of debt, available guarantees, credit rating of the borrower, terms of the loan (duration, currency, etc.), and market conditions).
 - In addition, domestic rules unrelated to the arm's length principle sometimes apply to restrict the deductibility of interest paid to a parent company.
- Is the amount of debt excessive? Is Taxpayer under-capitalised?
 - The arm's length principle may assist in the determination of an arm's length amount of debt in view of the lender's and borrower's circumstances. However, not all OECD countries agree that undercapitalisation issues / excessive indebtedness fall within the scope of the arm's length principle and can be resolved with transfer pricing techniques.
 - In addition, domestic rules unrelated to the arm's length principle sometimes apply to restrict the deductibility of interest paid to a parent company on loans over a certain threshold.
- Are the loan and acquisition in the interest of Taxpayer or of the parent company?
 - In many countries, the deductibility of interest charges may be denied if it is found that the loan and acquisition were not made in the commercial interest of Taxpayer. Where relevant, transfer pricing notions related to commercial rationality may assist in this determination.

QUESTION 7

OECD guidance on the transfer pricing aspects of intangibles is currently found in the TPG, especially in Chapters VI and VIII. Further guidance is available in the revised Chapters I-III of the TPG and in the new Chapter IX on the Transfer Pricing Aspects of Business Restructuring which were approved by the Council of the OECD in July 2010. Intangibles are also addressed in the July 2008 Report on the Attribution of Profits to Permanent Establishments and in the Commentary on Article 12 of the Model Tax Convention.

From a transfer pricing perspective, the more valuable the functions performed, the assets used and the risks assumed by an entity, the higher the profit potential allocated to it. In this respect, the greatest share of the profit potential is generally found to be attributed to intangibles and entrepreneurial, non-diversifiable risks. Identifying intangibles used in a controlled transaction (e.g. manufacturing, distribution, services) and their role in the value creation is important to select and apply the most appropriate transfer pricing method to the circumstances of the transaction. There are also many transactions which solely or mainly relate to intangibles (e.g. cost contribution / cost sharing arrangements, R&D activities, sales / licences / put at disposal of intangibles).

Intangibles being by nature potentially geographically mobile, many tax authorities scrutinise intangible transfers and the transfers of profit potential that typically go with them and require such transfers to be made at arm's length conditions.

Key issues in relation to the transfer pricing aspects of intangibles include:

- Definition of intangibles: beyond traditional ones (brand names, trademarks, patents, know-how...) there are emerging issues in relation to “soft” intangibles such as workforce in place, business opportunities, first in market advantage, etc which are not legally protected but may nevertheless significantly contribute to the value creation.
- A side issue is how to differentiate intangibles from services, in particular in the area of know-how.
- Many disputes arise with respect to the identification of intangibles and of intangible transfers.
- Valuation of intangibles; acceptability of forward-looking methods (e.g. discounted cash flow); parameters used in such methods (e.g. interest rate, risk discount rates).
- Right of an enterprise to share in the return from an intangible that it does not own; legal versus economic ownership.
- Cost contribution / cost sharing agreements raise specific issues in relation to the valuation of the contributions made by participants; “platform contributions”; buy-in / buy-out payments; risk allocation among participants; etc.
- Some intangible-related arrangements may raise issues in relation to commercial rationality and economic substance.