Question 1

Part 1

The Resale Price Minus Method(RPM) is a transfer pricing method use generally by distribution companies in order to determine the arm's length price of transactions with related parties.

The method generally works back from the final resale price of the goods or services party to the transaction and determines the gross margin that would be expected from the sale of the good or service. By applying the gross margin to the sale proceeds the transfer price for the connected party purchase of the goods or services can be determined.

Internal or external comparables can be used to determine the gross profit margin.

For CarCo the simpler tested party would be the distributor and as they sell the cars to third parties the resale price method could be used to determine the value of the packaging services they provide. Assuming the CUP method cannot be used the resale price method would be a suitable alternative. Benchmarking data should be available for toy cars as these are low value.

For TVco the RPM method is unlikely to be appropriate. As this entity sells onto a related party who is not the final distributor in the value chain it should not be used to determine the value of the transaction between TVco and the Taiwan sister company. The inter-company transaction between the German distribution company and Taiwan company could use the RPM as the German entity sells onto third parties.

For UK Mining Co the RPM is not an appropriate TP method to use. The Dutch company does more than simply distrubute the diamonds, the work undertaken to manufacture prior to sale will increase the value of the diamonds and the resale price method is unlikely to capture the functions performed and value added by the manufacturing company.

Part 2

The CUP method compares the price charged in a related party transaction to that charged in an unrelated transaction. Comparables can either be internal (i.e. the same company also has transactions with unrelated parties) or external (two unrelated parties).

When considering the CUP method the 5 comparability factors should be considered.

- Characterisation of goods and services
In all of the transactions listed the goods are toy boats. There is no mention that the product is different so arguably all meet this criteria

- Contractual Terms
We know that the same contract terms have been applied to the sale of the goods to related companies in Japan. However, whilst the terms of the contracts may be the same the sales are to related parties and not third parties so these are not comparable. The contractual terms for the sale to third parties in Germany are different, however it may be possible to provide for compensating adjustments in respect of the differences, for example what is the value of the longer settlement terms and the exchange rate risk. These should not be difficult compensating adjustments and third party comparables may also be available for disposals to toy boat distributors in Germany.

- Functional Analysis
When considering if the transactions are comparable you need to consider whether the parties to the transactions undertake the same functions. The UK retailers have different functions to distributors and are arguably not comparable.

- Business Strategies
Little detail is given regarding the business strategies of the entities but these should be taken into account when reviewing the comparable. The business strategy of selling to ToysFR may be to provide them with exclusive rights for sale and hence will mean different terms will apply and this is unlikely to be comparable.

- Economic circumstances
We are not told where Boat Co is located but assuming it is Europe then the German market would be the most comparable and this would represent sales to the same location as the controlled transaction. Sales to Japan could have barriers i.e. specifications for toys to meet a certain standard. The sales to distribution companies in German is the most reasonable comparable adjustments can be made should provide the most reliable internal CUP.

Part 3

The Cost Plus method determines an appropriate gross profit margin mark up which should be applied to costs (direct costs) in order to determine the arm's length return.

<u>Scenario A</u>

As a contract manufacturer UKBrakes is a cost intensive entity and therefore cost plus may be appropriate. The fact that it conducts Research and development should not prevent the cost plus method from applying unless the value of the R&D work is high value and creates valuable IP for the group.

For cost plus to apply the tested party should have limited risks and arguably as a contract manufacturer UKBrakes will be a low risk entity. It is not clear however whether it has any risk relating to the R&D it undertakes.

On the basis the R&D work is not high value creating R&D cost plus should be a possible TP method. If gross margin comparables are not available for the sale of brakes it may be possible to use TNMM with a cost basis.

<u>Scenario B</u>

Cost plus is a common TP method for intra group services. However accounting policies can make it difficult to apply the cost plus method on its own. The direct costs of providing the management charge by UKHoldCo may differ to those in comparable data from benchmarking studies. It would be better to use the transaction net margin method, which would use a net margin rather than gross margin to determine the mark up. This method can be applied to all costs.

Scenario C

The indication in the question is that there is a third party comparable available. It is not clear exactly what UKMaker does as manufacture but they add little value to the goods. The goods are acquired from US Inc and a third unconnected party. Arguably in this case the CUP method should be applied instead of cost plus.

Part 4

When considering intra-group services you must first ascertain whether a services has in fact been rendered. The services which are listed include relatively common back office services such as financial and legal services. GeorgiaCo is a distribution entity and would likely use the marketing services provided. It also has the risk of after sales services so will use the legal services also.

However, within the Finance services there are shareholder services for preparation of the consolidated accounts. Services which provide no benefit should not be charged for. Also duplicate services, so if Georgia co has any legal or marketing in-house they may not want to pay for these services.

Once it is determined services have been provided the value of those services must be considered. The current pricing strategy of 3% of sales may be relevant for the marketing services, however a direct charge may be able to be made for the legal services depending on their use and the complexity of local regulations.

Question 2

Part 1A

A functional analysis is the review of an entities functions that it performs, the assets it owns and the risks it assumes.

As the tax authority in Country D in order to undertaken a functional analysis of Sub B Co X the first step would be to review the accounting data of the sub and carry out research into the company using online resources. Assuming further information is needed a tax audit will be required. Only with a tax audit can the full functions of SubCo X be fully understood (unless TP documentation has been filed with the return).

Following the introduction by many countries of the OECD recommended documentation requirements it may be possible to obtain other TP documentation from Country C relating to the master file or country by country report.

The functions performed by Sub X will need to be reviewed. Their net profit is much lower than the gross profit which suggests that Sub X incurs expenses relating to its distribution activities. A review of exactly what functions Sub X undertakes will need to be conducted, for example do the offer after sales services?, Do they carry out marketing locally?

The assets owned should be visible from the Balance Sheet, however they may own value IP such as marketing IP or technical know how for the high spec bike that is sold.

The risks assumed will need to be considered. Do they provide warranty in respect of the bikes sold?

The tax authority also need to consider the appropriateness of the comparable found. For example the contractual terms between Y co and Sub X allow for exclusive rights to sell the high spec bike. They do not have the same contractual terms for the mid-rage bike as this is sold by A and B.

Likewise the characteristics of the goods are different Sub X sells are high spec bike, whereas A&B sell a mid-range bike.

Part 1B

The risk for Country D is that the purchase price Sub X pays for the bikes from Parent Y is above the arm's length price (i.e. what two unrelated parties would agree to) and that profits which should arise in and be taxed in Country D are being taxed in Country C instead.

Part 2A

Sub X is a distribution entity. It undertakes marketing activities on behalf of the group sells products to third parties.

The CUP method should be considered first - this method is unlikely to be possible due to the lack of comparison between the goods being sold. The bikes specifications differ and therefore the price also will not be comparable.

The resale price method could be used with the gross profit margins for Companies A & B being used to determine the arm's length value, however consideration would be needed to the additional work

undertaken by Sub X with regard to the marketing and also the additional risks assumed by Sub X with regard to the stock risk for any unsold bikes and also the warranty services (although CompanyA also offers this).

The cost plus method is not appropriate as Sub X is not cost intensive.

The transactional net margin method (TNMM) which uses a profit level indicator. Arguably this method is the most appropriate. The companies A & B could be used as comparables because they also sell a high spec bike that is different from general bikes, and the slight difference in type wouldn't affect the net profit as much as it may the gross margin.

Determine the net profit of Sub X using a designated profit level indicator. As a distributor who markets their products intensively sales may be chosen for SubX.

Once the profit level indicator has been determined the net profit should be calculated.

Comparables will need to be selected to compare. In this case Company A and B have been used, however comparability adjustments will need to be undertaken to account for the differences in the functions undertaken by the two. Company A is a low risk distributor whose only risk is warranty. Company B is a low risk distributor.

Sub X undertaken valuable marketing services and also has more assumed risk.

Profit split is unlikely to be appropriate because there is not valuable IP added by more than one party.

Part 2B

Need to adjust for differences in products and functions undertaken. See above.

<u>Question 3</u>

Part 1

<u>Weakness 1 - Definition - conducts business</u>

The definition of "conducts business" only stipulates that the TP legislation will apply to the purchase and sale of goods.

Arguably transactions involving related party services will not fall within the new legislation.

The definition should be updated to ensure the purchase or sale of services is included.

<u>Weakness 2 - Definition - related enterprise</u>

The related party definition is arguably too wide. An enterprise which a resident of Estria purchases or sells goods to will be included. This will arguably include all transactions for a resident entity and not just related parties.

The subsection 2 of the related enterprise definition does try to provide some limit but an entity can purchase over 50% of it's stock or goods and services from an unrelated party.

The definition should include some mention of control. Transfer pricing relates to services between associated enterprises. There needs to be an element of control between the parties in order to be associated and to prevent genuine third party transactions falling within the new regulations.

<u>Weakness 3 - Documentation Requirements</u>

The explanation that comprehensive documentation is needed will require further explanation. What exactly is comprehensive? Tax authorities need to ensure that any administrative burdens placed on taxpayers are not too onerous. They also need to consider whether they have the resources to review and manage all of the documentation that will be submitted.

Clarification should be provided with regards to what "comprehensive" means, but they should also consider whether thresholds are relevant for submission of TP documentation to ensure only those larger MNEs submit documentation.

They should use the OECD work on BEPS action 13 as guidance for what documentation to request from taxpayers and possible thresholds.

Another requirement of the documentation is that it is provided annually. Many MNEs undertake a review of their TP policies and reports each year, and do update transfer prices for changes when necessary. Requiring taxpayers to provide the documentation annually could result in the same documentation being submitted each year or if a complete review is required each year could be a costly exercise for taxpayers and discourage investment into the country.

<u>Weakness 4 – Penalties</u>

The penalty system could be quite burdensome. 4% applied to underpaid tax when millions or billions are involved will be significant for taxpayers. The documentation requirements as noted above are onerous and to apply a restriction to use transfer pricing documentation in a juridical process will put

the taxpayer at a significant disadvantage. Not all groups prepare TP documentation prior to a transaction, some prepare documentation following the transaction.

Having such a harsh penalty regime could result in businesses choosing not to invest in Estria. They need to balance their penalty system to ensure taxpayers are encouraged to ensure they have relevant TP documentation is place. The restriction for use in juridical proceedings should be removed.

Part 2

Other considerations for the EIRD are to include a section relating to compensating adjustments. As allowed under Article 9(2) of the Model DTA this will enable taxpayers to obtain relief where a transfer pricing adjustment is made and help to ensure double taxation following the TP adjustment does not arise.

They should also consider whether they wish to introduce Advance Pricing Agreements (APAs). Considering the documentation requirements and penalties attached to these, taxpayers may want certainly with regard to their TP treatment for transactions involving Estria resident entities. The tax authority may wish to restrict this service to only the larger taxpayers/transactions to ensure resources are not overloaded.

Estria may wish to introduce general anti avoidance legislation to ensure that all transactions have a commercial or business substance to them and have not been undertaken solely for tax avoidance purposes.

Question 5

Part 1

A functional analysis will show the changes to Zco from pre-reorg, to post-reorg.

Functions

Prior to the reorganisation Zco undertook manufacturing, distribution and marketing functions, undertaking R&D work. Following the purchase and subsequent reorganisations the marketing(retail) functions of the business have been transferred. There is no mention of the manufacturing activities, however Zco is noted as being a distribution entity. It's functions have therefore significantly reduced. As a low risk distributor Zco will act solely as a distributor.

Assets

Prior to the reorganisation ZCo owned valuable IP, customer lists for marketing purposes, valuable contracts and also manufacturing assets. They also had large staff assets with regard to the sales and marketing team. The R&D staff are also likely to be valuable staff assets.

Following the reorganisation the IP has been transferred, customer contracts and customer lists have all been transferred. As a distributor Zco has very few assets remaining. It will have retained local marketing customer lists and know how and some staff. Assuming they have retained their manufacturing functions they will have retained some local know how and manufacturing assets. It is not clear if this is the case as they are described as a low risk distributor, which suggests the manufacturing was transferred but it is not clear to whom.

Risks

Prior to the reorganisation Zco assumed risk for all functions. It had the R&D risk of new pharmaceutical products failing, it had sole market risk, forex risk, industry specific risks (such as regulation) and contract and warranty risks on all it products.

Following the reorganisation the risks have reduced considerably. As a low risk distributor they may have some contract risk but the vast majority of the risk has been transferred out.

Post Restructuring Transactions

Following the transfer of the IP Zco now pays a royalty in return for use of the license from VCo.

This transaction between related parties will need to be valued and the level of the royalty determined in accordance with the ALP. If the royalty payment is above the arm's length price(ALP) then Article 12 could deny the deduction and double taxation could arise on any excessive payment.

Part 2

The arm's length value compares the price that unconnected parties to a transaction would agree. This applies to good and services, but also to the transfer of trade and assets and intangible property.

In this case the majority of the trade and assets of Zco have been transferred to different entities in the group. Consideration should be given to whether a third party would agree to such a

reorganisation, and if it did what expected consideration it would expect from the sale of it's trade and assets and valuable IP.

ZCo has had the majority of its trade transferred out. A third party may not agree to such terms, particularly the licence back of IP from VCo. The justification for the reorganisation was to move ZCo into the group operating model and for cost efficiency savings.

Tax authorities may look closely at this reasoning particularly where IP or valuable services have been moved from a high tax jurisdiction to a low tax jurisdiction.

It is arguable that ZCo may have agreed to the transfer as it will be guaranteed to be a profit making entity going forward, whereas losses had arisen in prior years.

Considerations when looking at a reorganisation are ensuring that the transfers have actually taken place and the new entities assuming the functions, assets and risks have the capacity to do so.

Question 8

Transfer Pricing was originally an accounting concept. For groups to ensure profits were split correctly around group entities.

It is arguable this is still the case, however due to the tax landscape and tax planning progressing transfer pricing has recently been viewed as a method to prevent tax avoidance by MNEs.

Whilst many MNEs do still use TP in order to ensure that group companies contributions and results are monitored. However it can also be used to manipulate and save tax. By relocating services to low cost locations real costs savings are made, transfer pricing will ensure that any location savings which are not passed onto the customers will be realised by the low tax jurisdiction.

Transfer Pricing aims to ensure that groups cannot transfer valuable assets to low tax jurisdictions without ensuring substance is present.

TP encourages anti-avoidance by ensuring groups have sufficient commercial justification for their transactions and documentation in place.

The BEPS project is arguably an indication that TP has not been entirely successful in preventing abuse and the OECD have recommended 14 Actions to help improve the tax global landscape.

Transfer Pricing is a key component in BEPS and arguably TP will be even more effective at preventing tax abuse and harmful tax practices in the future.

In conclusion, I do not entirely agree with the statement. The aim of TP is not to directly impose anti avoidance on MNES but to ensure that all transactions are fairly priced and that profits are realised in the locations where there is substance and functions are performed, assets located and risks assumed.

It should be used in conjunction with general anti avoidance rules to ensure that tax transactions are not undertaken purely for tax avoidance and non-commercial reasons.