THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

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PAPER 3.03 – TRANSFER PRICING OPTION

Suggested Solutions

PART A

Question 1

1.1

Reference is made to the OECD Transfer Pricing Guidelines (2010); Chapter II – Transfer Pricing Methods, Part II: Traditional transaction methods, specifically section C – Resale price method.

CarCo

A resale price method would be considered as the most appropriate method to apply given the subsidiaries in Europe and Asia are essentially a re-seller of the same products; they do not alter the products and merely perform a packaging function for distribution. The costs of the packaging function may be considered when comparing the gross margin data earned by comparable and third parties.

TVCo

A resale price method would not be considered to be the most appropriate method to apply given that the functions performed by the sister company in Taiwan are more intensive than a re-seller with marketing/distribution functions, i.e. a manufacturing and assembly function that substantially adds more value and would impact comparability of gross margin data.

UK Mining Co

A resale price method would not be considered to be the most appropriate method to apply given that the Dutch Co adds substantial value to the product it purchases from UK Mining co through a manufacturing function which also changes the nature of the product – i.e. from unprocessed product to jewellery for sale. This would impact comparability of gross margin data.

1.2

Reference is made to the OECD Transfer Pricing Guidelines (2010); Chapter II – Transfer Pricing Methods, Part II: Traditional transaction methods, specifically section B – Comparable uncontrolled price method and section A.4 and section D.1.2 – Factors determining comparability.

Sales to retailers in the UK

Same product, different market (UK and Germany may not be a major comparability issue with regard to economic circumstances), therefore is arguably a valid comparable for the purpose of applying the Comparable Uncontrolled Price Method.

Sales to related companies in Japan

Same product and terms but different market (potentially different economic circumstances which would impact the validity of comparability).

Sales to distribution companies in Germany

Same product and market/economic circumstances however different contractual terms (exchange rate risk and terms of trade; settlement terms) – unless reliable adjustments can be made to account for the contractual terms, this would not be considered to be a valid comparable.

Sales to ToysFR

Same product, different country (however, may not impact comparability given both in the European market) and assuming no issue with contractual terms, would be considered to be a valid comparable for the purpose of applying the Comparable Uncontrolled Price Method.

1.3

Reference is made to the OECD Transfer Pricing Guidelines (2010); Chapter II – Transfer Pricing Methods, Part II: Traditional transaction methods, specifically section D – Cost plus method and section A.4 and section D.1.2 – Factors determining comparability:

UKBrakes

The cost plus methodology would be appropriate here given UKBrakes is essentially performing a contract research and development function on behalf of the US head company.

UKHoldco

The cost plus methodology would be appropriate here given a services are being performed by UKHoldco for the benefit of its Swedish subsidiary. The UKHoldco would potentially charge its Swedish subsidiary for the costs incurred in performing the services (using an allocation key of labour hours for example) with an arm’s length margin.

UKMaker

The cost plus methodology would not be the most appropriate given a resale price method may be more appropriate (not purchasing semi-finished goods and a comparable).

1.4

The payment of 3% of sales for intragroup services provided SlovakCo is arguably the incorrect methodology relative to the functions, assets and risks involved in the controlled transaction. The administrative services provided by SlovakCo could be considered as more routine services as opposed to value added services. Further, SlovakCo are not assuming a high degree of risk nor utilising assets including the use of intellectual property. To that end, it arguable that a cost plus methodology would be more appropriate – i.e. a markup on the costs incurred by SlovakCo in providing the routine services to its subsidiaries.

Question 2

2.1

Reference is made to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (July 2010), Chapter I – The Arm's Length Principle; D.1.2.2 – Functional Analysis.

The functional analysis seeks to identify and compare the economically significant activities and responsibilities undertaken, assets used and risks assumed by the parties to the transactions. For this purpose, it may be helpful to understand the structure and organisation of the group and how they influence the context in which the taxpayer operates. It will also be relevant to determine the legal rights and obligations of the taxpayer in performing its functions. In addition, it is important to understand the industry and economic conditions of the market in which the companies are operating as well as their business model and strategies.

The functions of SubCo X should be identified including the economic significance of those functions in terms of their frequency, nature and value to the respective parties. In this situation, SubCo X is primarily performing a distribution functions (i.e. distributing high-grade professional-use bicycles in Country D). It is noted that SubCo X has exclusive distribution rights of the high grade bicycles in Country D. SubCo X does not manufacture the bicycles, rather, it purchases the bicycles from its related party, ParentCo Y, who are the manufacturer in Country C.

SubCo X would also undertake a marketing and sales functions in Country D; this would involve sales and marketing staff developing and implementing marketing strategies and budgets and pushing the product through the distribution channels in the market to customers (e.g. retail stores, online, end customers); marketing intensity. This goes to an understanding of the supply chain and global value chain for the group to understand the functions, assets and risks of SubCo X and its related parties with regard to the economic contribution and remuneration. The level of marketing intensity of SubCo X is important as it is a function that will impact the level of sales and is a cost incurred in running the business in the market. SubCo X may also be able to generate marketing intangibles in Country D; e.g. customer relationships).

The functional analysis should also consider the type of assets used and the nature and nature of the assets used, such as the age, market value, location, property right protections available, etc. In this situation, it would need to be determined if SubCo X owns any intangible assets (e.g. patents or tradenames of the bicycles); this would most likely be held with the manufacturer, ParentCo Y, however may be held by another related entity within the global group. The number of staff within various functional areas would need to be identified, along with any tangible assets such as offices, warehouses, etc.

The functional analysis should consider the risk assumed for each party such as market risk, such as input cost and output price, fluctuations; risk of loss associated with the investment in and use of property plant and equipment, risks of investment in research and development; financial risks such as those caused by currency rate and interest rate variability; credit risks, etc. The risks identified generally would follow the functions performed by the parties within the group. For example, a full-fledged manufacturer would typically have a great risk profile than a low risk distributor which in turn links to the level of remuneration/compensation.

In terms of practical approaches to this situation, the functional analysis could be undertaken not only by reviewing documents provided by SubCo X and ParentCo Y, but by conducting interviews of a selection of the staff in SubCo X to establish the skill base and understand fully the functions performed and the decision making processes adopted. Staff interviewed could include relevant operational, marketing / sales, managerial, finance and accounting staff. Any documents in existence with regard to the exclusive distribution rights for SubCo X would also need to be understood as well as if SubCo X is paying a royalty for the high end products it is purchasing from ParentCo Y (e.g. a license agreement in place?) or is there a royalty embedded in the purchase price of the products?

Some further questions that could be raised with regard to identifying economically important activities of SubCo X through the functional analysis could include:

- What is the nature of your business?
- How does your enterprise add value?
- What is affecting/driving the performance of your business?

- Are there any unique factors in your success?
- What examples are there of cases where the strategies/success factors did not work?
- What assistance do you receive and what transfers have been made to and from the business?

SubCo X therefore, following a functional analysis and on the basis of the facts provided, could be characterised as a low risk distributor / marketer of high end bicycles.

The key transfer pricing risks for the Tax Authority of Country D would be:

- the purchase price paid by SubCo X to ParentCo Y, in Country C, is greater than an arm's length price;
- SubCo X is not being remunerated on an arm's length basis for its characterisation of a low risk distributor / marketer of high end bicycles; and
- SubCo X is bearing more risks than a low risk distributor and not being reimbursed/remunerated on an arm's length basis.

2.2

A resale price method would arguably be the considered to be the most appropriate method to apply in this situation. SubCo X does not add substantial value to the product that it resells to customers and marketing functions are performed. The resale price method begins with the price at which a product that has been purchased from an associated enterprise (ParentCo Y) is resold to an independent enterprise. The price (the resale price) is then reduced by an appropriate gross margin on this price (the resale price margin) representing the amount of which the reseller (SubCo X) would seek to cover its selling and other operating expenses and, in the light of the functions performed (taking into account assets used and risks assumed), make an appropriate profit.

What is left after subtracting the gross margin can be regarded, after adjustment for associated costs associated with the purchase of the product, as an arm's length price for the original transfer of property between the associated enterprises. The resale price method in this situation would require a comparison of the functions undertaken by SubCo X and the resulting gross margin obtained in its controlled dealings against the resale price margin earned by independent enterprises in comparable uncontrolled dealings (i.e. Company A and B, also operating in Country D). There are no valuable or unique intangibles involved in the transactions and less product similarity may be required using a resale price method. SubCo X, Company A and Company B are not adding any value or changing the nature of the product being resold. However, exclusive distribution rights, any valuable tradenames or differences in accounting practices may impact the resale price method application.

The resale price method depends on comparability of functions performed (taking into account assets used and risk assumed). It may become less reliable when there are differences between the controlled and uncontrolled transactions and the parties to the transactions, and those differences have a material effect on the attribute being used to measure arm's length conditions, in this case the resale price margin realised. Where there are differences that affect the gross margins earned by the controlled and uncontrolled transactions, adjustments should be made to account for such differences. SubCo X has an exclusive right to distribute the Type S bicycle into Country D; this would potentially affect the resale price margin and should be taken into account in the comparison. The level of sales and intensity of advertising/marketing expenses/intensity could be considered in this regard. This extends to the advertising activity of SubCo X relative to the independent parties, Company A and Company B in Country D; the intensity and marketing expenditure of each company needs to be examined and could be used in any adjustment to the resale price.

The comparability differences in relation to sales policy and inventory risk would necessitate a comparability adjustment with regard to inventory risk / obsolescence risk (inventory loss figures could be used). Additionally, product warranty service would mandate a comparability adjustment given Company B does not provide a warranty service to their customers (warranty expenses could be used). Therefore, it is clear that the amount of the resale price margin will be influenced by the level of activities performed by the reseller and needs to be taken into account with any comparison.

A controlled uncontrolled price method would not be considered to be the most appropriate method to apply in this situation on the basis that the product differences (quality and functions) that effect the price between the Type S and T bicycles, which would arguably preclude accurate adjustments and therefore reliability of the comparability would be impacted.

A cost plus method would not be considered to be the most appropriate method in this situation on the basis that the goods transferred between related parties are not semi-finished goods nor services.

A profit split method would not be considered to be the most appropriate method in this situation on the basis that both parties are not contributing towards the generation of valuable intangibles or operating a highly integrated business.

PART B

Question 3

3.1

Weaknesses are as follows:

- Conducts business only covers goods and does not extend to services leaving a large gap for possible exploitation;
- Definition of Related enterprise is odd as it focuses on trading between the parties and not shareholding, etc.
- Documentation is very non-specific. What does the documentation need to reveal? Does it need to be contemporaneous with the transaction to which it relates?
- Penalties are way to light – a 4% penalty may encourage parties to have a go rather than act as a deterrent.
- Price focus is too narrow – perhaps a focus on commensurate profits would be more acceptable
- No reference to acceptable methodologies.

3.2

Three additional requirements are required. Any of the following may be used:

- Mechanism for advance pricing agreements.
- A section listing documentation requirements.
- A section spelling out acceptable methods and the circumstances where each would be acceptable.
- A time limit for adjustments so as to give taxpayers some certainty into the future.

Question 4

4.1

What is a CCA?A contractual arrangement among business enterprises to share the contributions and risks involved in the joint development, production or the obtaining of intangibles, tangible assets or services with the understanding that such intangibles, tangible assets or services are expected to create direct benefits.

Explain that it does not involve the revenue authorities.

Explain who the parties are.

Key terms.

4.2

What is an APA and the benefits; is an ahead-of-time agreement between a taxpayer and a tax authority on an appropriate transfer pricing methodology (TPM) for a set of transactions at issue over a fixed period of time (called "Covered Transactions"). Provides the parties with certainty over the arm’s length pricing of transactions for a future period.

Explain who the parties are.

Explain how long it lasts.

Key terms, including assumptions upon which the APA relies.

4.3

Stress the contemporaneous nature of the documentation.

Explain that a series of EBIT/Sales data has been collected and that outliers were eliminated and the average of the balances was ascertained.

The tested ratio was then compared to the range and if it fell well within that range, it was accepted as being satisfactory. Otherwise, need to make an adjustment to bring within the range.

Explain why EBIT/Sales profit level indicator was used, why other ratios were rejected, and why other methods were rejected.

PART C

Question 5

Reference is made to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (July 2010), Chapter IX – Transfer Pricing Aspects of Business Restructurings and the following sections:

- Part II: Arm's length compensation for the restructuring itself:
  - B.1: Identifying the restructuring transactions: functions, assets and risks before and after the restructuring;
  - B.2: Understanding the business reasons for the expected benefits from the restructuring, including the role of synergies;
  - B.3: Other options realistically available to the parties;
  - C.1: Profit potential;
  - C.2: Reallocation of risks and profit potential;
  - D: Transfer of something of value (e.g. an asset or an ongoing concern); and
  - E: Indemnification of the restructured entity for the termination or substantial renegotiation of existing arrangements.
- Part III: Remuneration of post-restructuring controlled transactions:
  - D: Comparing the pre- and post-restructuring situations; and
  - F: Example: implementation of a central purchasing function.
- Part IV: Recognition of the actual transactions undertaken:
  - C.2: Determining the economic substance of a transaction or arrangement;
  - C.3: Determining whether arrangements would have been adopted by independent enterprises;
  - C.4: Determining whether a transaction or arrangement has an arm's length pricing solution;
  - D.1: Example (A): Conversion of a full-fledged distributor into a "risk-less" distributor; and
  - D.2: Example (B): Transfer of valuable intangible to a shell company.

The functions, assets and risks of ZCo – pre and post business restructuring needs to addressed and are summarised as follows:

'Pre' restructuring

Functions	Assets	Risks
Manufacturing Distribution Marketing and sales Research and Development Regulatory Formulation Packaging and labelling Quality control Purchasing and inventory management (supply chain)	Tangible – property, plant and equipment (manufacturing assets, warehouses and offices, etc.), human capital Intangible – intellectual property (patents, trademarks, know-how / manufacturing process, distribution/supply rights, retail points)	Market risk Research and Development risk Inventory risk Product liability / obsolescence risk Financial risk Credit risk Foreign currency risk Environmental risk Regulatory risk

ZCo 'pre' restructuring would be characterised as a full- fledged manufacturer and distributor of pharmaceutical products. It owns all the manufacturing intangibles, assumes all the product related risks, performs all functions related to manufacturing at all stages of the product life cycle and utilises tangible and intangible assets.

'Post' restructuring

Functions	Assets	Risks
Distribution Marketing and sales	Tangible – offices, warehouses (unless outsourced), human capital	Market risk Credit risk

ZCo 'post' restructuring would be characterised as a low risk distributor and marketer of pharmaceutical products. It is removed from all the risks borne by a full-fledged manufacturer and does not own valuable intellectual property.

Understanding this restructure involves an understanding of the functional, assets and risks (noted above) and how they have changed as a result of the restructure for ZCo (a pre/post analysis). In addition, how the characterisation has changed for ZCo. It is clear that as a result of the restructure, ZCo has shifted from a full-fledged manufacturer and distributor to a low risk distributor of pharmaceutical products.

In order to determine the arm's length compensation payable upon a restructuring to any restructured entity with an MNE group, as well as the member of the group that should bear such compensation, it is important to identify the transaction or transactions occurring between the restructured entity (ZCo) and one or more other members of the group (VCo, WCo and XCo). This includes any transfer of any rights and obligations of the restructured entity.

The business / commercial reasons for and the expected benefits and possible synergies from the restructuring needs to be understood. In this situation, ZCo has been restructured (or 'stripped down') to a low risk distributor. The commercial rationale provided the MNE was that the group was aligning ZCo's operating model to the operating model of the MNE group, following acquisition of ZCo. The documentation of the expected benefits/synergies to be derived for all entities within the group would been to be considered. This would include the options commercially available to the parties at the time of the decision making and any cost benefit analysis and forecasting/modelling by the parties.

In terms of an arm's length outcome for ZCo, the two main factors with regard to profitability would be the compensation received for the sale of intellectual property (tradenames, etc), supplier contracts, retail points and tangible assets (valuation issue) and the profit potential for the future or expected future benefits. Without ownership of the valuable intellectual property, ZCo would not have the ability to generate residual profits (or losses) above a potential guaranteed return as a low risk distributor. Further, would an independent party sell its value intellectual property and then pay a royalty to license it back? It is noted that ZCo did incur losses for two years (as the entrepreneur owning intangibles and bearing product risk), however, this would need to be balanced with a forecast future profitability relative to the routine return as a low risk distributor. Does the restructure from the perspective of ZCo makes commercial sense in terms of the benefits received?

Question 6

DSG

The case concerned a dispute between HMRC and a group of companies which form the largest retailer of electrical goods in the UK, comprising Dixons, Currys and PC World. DSG Retail Ltd (DSG) was the retail company. DSG had a subsidiary, CIS. CIS, acting as agent for Cornhill Insurance plc (Cornhill), offered DSG's customers extended warranties on electrical goods. Cornhill paid CIS a sales commission.

From May 1986 to April 1997 Cornhill was the insurer of the extended warranties sold to DSG's customers, retaining 5% of the risk and reinsuring 95% with a subsidiary of DSG that was incorporated in the Isle of Man, DISL. Cornhill ceded 95% of the risk premiums it received to DISL under the reinsurance contract, and in return DISL paid Cornhill a ceding commission of 1.5% of the premiums ceded to it. DSG had no direct contractual relationship with DISL.

In 1993, the arrangements were extended for five years and the profit commission arrangements with CIS were altered so that Cornhill paid CIS a greater commission. Crucially, Cornhill agreed not to seek a corresponding increase in ceding commission from DISL.

From 1 April 1997, the rate of Insurance Premium Tax ("IPT") on the goods that DSG sold rose dramatically from the then standard rate of 2.5% to 17.5%. To avoid IPT, DSG restructured the arrangements so that instead of an insurance policy issued by Cornhill, customers were sold a service contract with ASL, an Isle of Man company independent of DSG. The fee charged for the repair contract did not attract IPT because it was not an insurance transaction. ASL insured its risk with DISL.

As a result of the agreements in place, a large proportion of the profits accumulated tax-free in the Isle of Man subsidiary, DISL. HMRC sought to bring a larger share of the profits into charge in the UK by invoking the transfer pricing rules and contending that the arrangements were not consistent with the arm's length principle. HMRC argued that an analysis of the transactions as a whole indicated that the DSG group had made an indirect provision to DISL of a business facility whereby Cornhill's position relative to DISL was disadvantaged. Cornhill's profit had been "squeezed" by the 1993 contractual changes whereas DISL's profit had not. HMRC argued that DISL's non-arm's length profit continued from 1997 under the new ASL arrangements in the form of an opportunity to enter into an attractive insurance contract. Applying arm's length terms, the DSG group would have required payment from an independent party to enter into the same arrangement.

From a transfer pricing perspective, the following issues were relevant:

1. Was there a provision between DSG and DISL for the purposes of Schedule 28AA ICTA?

2. Did the actual provision differ from the provision that would have been made between independent enterprises?

3. Did the provision confer a potential advantage in relation to UK tax?

4. What adjustment is required?

The relevant legislation covering the Cornhill period was section 770 of the Income and Corporation Taxes Act 1988. Section 770 applies to the sale of property between two parties, one of which controls the other or both of which are controlled by the same entity, where the actual price of the sale is different to that which would have been agreed by independent persons dealing at arm's length (the "arm's length price"). Section 770 dictates that the parties' income, profit or loss is to be computed for tax purposes as if the sale had been at the arm's length price. Section 773(4) extended the application of section 770 from the "sale of property" to the giving of "business facilities of whatever kind".

UK transfer pricing legislation underwent a significant change in 1998 with the introduction of a new section 770 and the addition of Schedule 28AA. Schedule 28AA is applicable for accounting periods ending after 30 June 1999, and is thus the governing legislation for the latter part of the ASL period. Schedule 28AA applies where a "provision" exists as between any two persons by means of a transaction or series of transactions and there is a relationship of common control between the persons. If the actual provision differs from the provision ("the arm's length provision") that would have been agreed as between independent enterprises and confers a potential advantage in relation to UK taxation on one or both of the affected persons, Schedule 28AA prescribes that the profits and losses of the potentially advantaged person (s) are to be computed for tax purposes as if the arm's length provision had been made or imposed instead of the actual provision.

The transfer pricing method used - DSG argued for the use of comparable uncontrolled prices, and relying on transfer pricing reports produced by a number of accounting firms, put forward a number of comparables in support of its argument.

HMRC rejected the comparables for reasons such as:

Time – the first comparable proposed concerned an agreement made in 1982 when the market for extended warranties was quite different to the market in 1997.

Product – the second comparable proposed concerned an agreement related principally to satellite equipment.

Termination – the second comparable was terminable on one week's notice which was interpreted as demonstrating that the parties were not contemplating a long term relationship, unlike the DSG arrangements.

Terms – DSG sought to rely on a 1994 report from the Office of Fair Trading, "Extended Warranties on Electrical Goods", which gave the commission rates paid by three unidentified retailers. There was no evidence as to whether the rates agreed were between arm's length parties or what the other terms were.

Bargaining position – DSG put forward a comparable involving a bargain between equals. This comparable was rejected because this was not the position with DISL.

On the basis that no comparables could be identified, HMRC's expert witness set out a profit split approach whereby DISL's profits would be compared to a notional "normal rate of return on investors' capital", based on the capital asset pricing model. A "bottom up" approach was preferred whereby it was assumed any profits in excess of capital needed for solvency requirements was paid out as a dividend each year. Solvency requirements were based on those contractually agreed with Cornhill.

It was held that there was clearly provision between DSG and DISL despite there being no direct contractual relationship between these entities. It was clear that in negotiations with Cornhill and with DSG's bargaining power, DISL had been given an advantage in order to provide tax benefits to the group. The Special Commissioners concluded that the arrangements were not at arm's length and that DSG set a price that "confers a potential advantage in relation to United Kingdom taxation" because DSG's profits did not include income it would have received for its provision of the business facility if DSG and DISL were dealing at arm's length. They also rejected the comparables put forward by DSG and supported the use of the type of profit split formula suggested by HMRC.

It was determined that DSG's profits should be adjusted to that of an arm's length arrangement based upon the above mentioned profit split method. Determination of the actual quantum of the adjustment was referred back to the parties to enable a settlement to be negotiated, but the tribunal held that the adjustment should take the form of a commission payable by DISL to DSG.

Perhaps of most interest for taxpayers are the arguments HMRC employed to challenge the comparables and the tribunal's receptivity to HMRC's arguments on pricing methodology which, although based upon the OECD Guidelines, may upset the traditional hierarchy of suggested transfer pricing methods as set out in the OECD Guidelines. It validates the use of profit based methodologies where reliable comparables cannot be found.

What is apparent from the case is that transfer pricing issues are never clear-cut; this particular hearing lasted 15 days and involved a lengthy and complex analysis of the contracts and transactions involved. It has been suggested that it signals a change in HMRC's previous reluctance to litigate transfer pricing issues, which serves to highlight the importance for groups to re-examine their transfer pricing policies and consider whether the most appropriate pricing methodology has been used. It also reinforces the importance of performing a sound economic analysis of commercial agreements. HMRC will construe the arrangements as a whole, and if it can show that the third party was engaged by a group entity only on the understanding that the third party would, in turn, enter into a contract with another entity from the group the transfer pricing legislation will apply.

<u>GE Capital</u>

The Tax Court of Canada's recent decision in General Electric Capital Canada Inc. v. The Queen provides an example of the court's application of transfer pricing rules in the Income Tax Act (Canada) (the "ITA") in the context of a guarantee arrangement between a non-resident parent and a Canadian subsidiary. In this case, the Canada Revenue Agency denied the deduction of $136 million in guarantee fees paid over several years by General Electric Capital Canada Inc. ("GEC") to its US-based parent. The court found that the guarantee fee of 1% per annum of the principal outstanding debt amount did not exceed an arm’s length price. Consequently, the court ruled in favour of GEC and allowed the deduction.

In this case, a US-based parent General Electric Capital Corporation ("Parent") guaranteed debt securities issued by a Canadian subsidiary GEC in consideration for a guarantee fee equal to 1% per annum of the principal amount of debt securities outstanding during a year. The Minister disallowed the deduction of a total of $136 million in guarantee fees paid to the Parent during its 1996 to 2000 taxation years.

Position of the Minister of National Revenue

The Minister argued that the guarantee provided no economic benefit to GEC and, therefore, its arm’s length price would have been nil. GEC enjoyed a so-called "implicit support" from its Parent. The Parent could never allow its like-named affiliate, such as GEC, to default on its debt because it would damage the Parent’s own AAA credit rating and increase its borrowing costs significantly. Due to this "implicit support" GEC would have had the same credit rating, could have borrowed the same amount of money at the same interest rate without the guarantee.

The Minister also added 5% withholding tax to the guarantee payments on the basis that the payment of the guarantee fees was deemed to be a payment of dividends which should be subject to withholding tax.

Position of GEC

GEC argued that it paid an arm’s length price for the guarantee. The transfer pricing rules invite the court to analyse a transaction between related entities as though they were unrelated parties. Consequently, all distortions that arise from the parties’ non arm’s length relationship, such as "implicit support," must be ignored and the Minister’s position is unfounded.

GEC argued that the Minister’s approach is flawed because it did not adduce evidence on what would be a price of a comparable arm’s length guarantee arrangement, as required by the transfer pricing rules; the basis of the Minister’s position was simply that the guarantee was not necessary in GEC’s business. Finally, GEC presented expert evidence that without the guarantee its credit rating would have been BB as opposed to AAA and its cost of borrowing would have been higher.

The Decision

In a lengthy and complicated judgement and after taking into account several expert opinions, the Tax Court of Canada determined that that the guarantee fee did not exceed an arm’s length price.

The court held that the factor of "implicit support" is relevant in an arm’s length analysis under the transfer pricing rules. It also noted that transfer pricing rules can apply if the value of the benefit received from a transaction is nil and, consequently, the transaction cannot be compared with an arm’s length transaction.

In its analysis, the court compared the borrowing cost of guaranteed debt as opposed to the borrowing cost of unguaranteed debt. By relying heavily on expert witnesses, the court determined that:

1. GEC’s stand-alone credit rating without the guarantee and without the "implicit support" from the Parent would have been B+ to BB-;

2. When the factor of "implicit support" from the Parent is taken into account, GEC’s rating without the guarantee would only go up to BBB-/BB+; and

3. The GEC’s interest cost savings afforded by the guarantee was approximately 1.83%. In this regard, the court also took into account that GEC’s investors would not welcome the removal of

the guarantee and would not have the same confidence in unguaranteed debt. The court recognized that the guarantee existed for many years and served a bona fide business purpose. The "implicit support" of the Parent could not replace the need for a guarantee as few investors are foolish enough to believe that the it is equivalent to a guarantee.

Based on this evidence, the court concluded that the 1% guarantee fee did not exceed an arm's length price because GEC "received a significant net economic benefit from the transaction."

The case is currently under appeal to the Federal Court of Appeal. The Federal Court of Appeal decision will undoubtedly be an important development in the law of transfer pricing in Canada.

Three transfer pricing-related issues in this case provided taxpayers with the following lessons to be learned:

- whether implicit support from the parent-subsidiary affiliation would reduce the net economic benefit to the subsidiary of an explicit financial guarantee;

- whether consideration of implicit support in determining the credit risk of the subsidiary is consistent with the concept of the arm's length principle; and

- provided the most appropriate transfer pricing methodology to determine an arm's-length guarantee fee for a financial (or loan) guarantee.

Parent-subsidiary affiliation It is clear from this case that, in the assessment of the credit risk of the subsidiary, the parent-subsidiary affiliation must be considered. This does not mean that this assessment will conclude that the parent-subsidiary affiliation will always result in the subsidiary's credit risk being improved or that its credit risk could be equalised with that of its parent's external credit rating. The assessment of implicit support is whether or not the debt market participants would, by reason of the parent-subsidiary affiliation, charge the subsidiary a lower rate of interest (or some other net economic benefit) without an explicit financial guarantee. It is not whether or not the credit rating agencies would notch the stand-alone credit rating.

This case offers a glimpse into the subjective criteria that credit rating agencies use for notching the stand-alone credit rating of the subsidiary for the parent-subsidiary affiliation. However, this subjective process may not be entirely representative of what lenders would consider in setting the interest rate.

The next lesson is that, in applying the arm's length principle, the ownership or shareholder relationship between the parent and subsidiary must be ignored so that the parties are transacting as if they were distinct and separate enterprises. So any benefit the guarantor-parent receives from providing the financial guarantee in its role as a shareholder of the subsidiary cannot be considered in determining the arm's-length guarantee fee. Conversely, any economic benefit the subsidiary receives as being a subsidiary of the parent must be ignored. Therefore, the subsidiary would not compensate the parent for any economic benefit it receives solely from the parent-subsidiary affiliation. This means that implicit support is consistent with the arm's length principle.

The final lesson in this case is that the selection and application of the most appropriate transfer pricing method to determine an arm's-length guarantee fee for a financial or loan guarantee must consider the economic benefit to the subsidiary (in other words, its interest rate savings as a result of the explicit financial guarantee). The interest rate savings method using corporate bond data in a yield spread analysis was used to test whether or not the guarantee fee was equal to, or less than, an arm's length guarantee fee. This case reinforced the importance of, and the difficulty in, determining the credit risk rating of the subsidiary. This is a critical first step in determining the arm's-length guarantee fee.

As part of the credit risk estimation process, it is not only necessary to determine the stand-alone credit risk of the subsidiary, but to also consider the impact of the parent-subsidiary affiliation (the implicit support) on the stand-alone credit risk.

Question 7

The inclusive framework brings together over 100 countries and jurisdictions to collaborate on the implementation of the OECD/ G20 Base Erosion and Profit Shifting (BEPS) Package.

BEPS refers to tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity. Although some of the schemes used are illegal, most are not. This undermines the fairness and integrity of tax systems because businesses that operate across borders can use BEPS to gain a competitive advantage over enterprises that operate at a domestic level. Moreover, when taxpayers see multinational corporations legally avoiding income tax, it undermines voluntary compliance by all taxpayers.

BEPS is of major significance for developing countries due to their heavy reliance on corporate income tax, particularly from multinational enterprises. Engaging developing countries in the international tax agenda is important to ensure that they receive support to address their specific needs.

Developing countries have been engaged since the beginning of the BEPS Project. Over 80 developing countries and other non-OECD/non-G20 economies discuss the challenges of BEPS through direct participation in the Committee on Fiscal Affairs, regional meetings in partnership with regional tax organisations, and thematic global fora. Many developing countries are now joining the inclusive framework.

Monitoring, review and standard setting in an inclusive framework

In response to the call of the G20 Leaders, OECD members and G20 countries have developed an inclusive framework on BEPS.

Monitoring implementation and the impact of the different BEPS measures is a key element of the work ahead. The OECD has established an inclusive framework on BEPS, which allows interested countries and jurisdictions to work with OECD and G20 members on developing standards on BEPS related issues and reviewing and monitoring the implementation of the whole BEPS Package.

Members of the inclusive framework will develop a monitoring process for the four minimum standards as well as put in place the review mechanisms for other elements of the BEPS Package. The monitoring of the four minimum standards will ensure that all members, as well as jurisdictions of relevance, will comply with the standards in order to ensure a level playing field. Monitoring mechanisms are going to be developed in order to monitor jurisdictions' compliance with their commitments. These mechanisms will ensure the effectiveness of the filing and dissemination of the Country-by-Country reports, as provided for by the review of the Country-by-Country standard by 2020. In regards to review mechanisms, they may differ depending on the Actions and will take into account countries' specific circumstances. All countries and jurisdictions joining the framework will participate in this review process, which allows members to review their own tax systems and to identify and remove elements raising BEPS risks.

The inclusive framework will also support the development of the toolkits for low-capacity developing countries. The G20 Development Working Group (G20 DWG) has requested the IMF, the OECD, the UN and the WBG to work together on the development of toolkits and guidance to support low-capacity developing countries to address BEPS issues. The toolkits are being prepared to help developing countries implementing measures to tackle BEPS as well as other issues that developing countries have identified as priorities during the regional consultations. The inclusive framework will allow members to feed their views into the toolkit work, and likewise the latter might impact the remaining BEPS standard-setting work.

The interaction between international organisations, although independent, will be connected with the inclusive framework. The involvement of the international organisations as Observers in the inclusive framework will facilitate their collaboration. It will offer participants the opportunity to receive coordinated and targeted capacity building support in the implementation of the BEPS outcomes.

Countries and jurisdictions have been invited to express their interest to join this framework as Associates, to participate on equal footing and to commit to implement the comprehensive BEPS Package. Timelines for implementation may differ to reflect the level of development of participating countries.

The OECD's Action Plan on BEPS was published in July 2013 with a view to addressing perceived flaws in international tax rules. The 40 page Action Plan, which was negotiated and drafted with the active participation of its member states, contained 15 separate action points or work streams, some of which were further split into specific actions or outputs. The Plan was squarely focused on addressing these issues in a coordinated, comprehensive manner, and was endorsed by G20 leaders and finance ministers at their summit in St. Petersburg in September 2013.

The recommendations of the BEPS Project led by the Organisation for Economic Cooperation and Development (OECD) and published in October 2015 are at the root of much of the coordinated activity, although the timing and methods of implementation vary. At the completion of this scheduled programme, it started to be recognised as the end of phase one of the project and the start of phase two, dealing with outstanding or additional work, implementation and monitoring.

Fundamental changes are needed to effectively prevent double non-taxation, as well as cases of no or low taxation associated with practices that artificially segregate taxable income from the activities that generate it.

New international standards must be designed to ensure the coherence of corporate income taxation at the international level.

A realignment of taxation and relevant substance is needed to restore the intended effects and benefits of international standards, which may not have kept pace with changing business models and technological developments.

The actions implemented to counter BEPS cannot succeed without further transparency, nor without certainty and predictability for business.

<u>Addressing the tax challenges of the digital economy</u>

Action 1 addresses the tax challenges of the digital economy and identifies the main difficulties that the digital economy poses for the application of existing international tax rules. The Report outlines options to address these difficulties, taking a holistic approach and considering both direct and indirect taxation.

<u>Neutralising the effects of hybrid mismatch arrangements</u>

Action 2 develops model treaty provisions and recommendations regarding the design of domestic rules to neutralise the effects of hybrid instruments and entities (e.g. double non-taxation, double deduction, long-term deferral).

<u>Designing effective controlled foreign company (CFC) rules</u>

Action 3 sets out recommendations to strengthen the rules for the taxation of controlled foreign corporations (CFC).

<u>Limiting base erosion involving interest deductions and other financial payments</u>

Action 4 outlines a common approach based on best practices for preventing base erosion through the use of interest expense, for example through the use of related-party and third-party debt to achieve excessive interest deductions or to finance the production of exempt or deferred income.

<u>Countering harmful tax practices more effectively, taking into account transparency and substance</u>

Action 5 revamps the work on harmful tax practices with a focus on improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes, and on requiring substantial activity for preferential regimes, such as IP regimes.

<u>Preventing the granting of treaty benefits in inappropriate circumstances</u>

Action 6 develops model treaty provisions and recommendations regarding the design of domestic rules to prevent treaty abuse.

Preventing the artificial avoidance of permanent establishment status

Action 7 contains changes to the definition of permanent establishment to prevent its artificial circumvention, e.g. via the use of commissionaire structures and the likes.

Aligning transfer pricing outcomes with value creation

Actions 8 – 10 contain transfer pricing guidance to assure that transfer pricing outcomes are in line with value creation in relation to intangibles, including hard-to-value ones, to risks and capital, and to other high-risk transactions.

Measuring and monitoring BEPS

Action 11 establishes methodologies to collect and analyse data on BEPS and the actions to address it, develops recommendations regarding indicators of the scale and economic impact of BEPS and ensure that tools are available to monitor and evaluates the effectiveness and economic impact of the actions taken to address BEPS on an ongoing basis.

Mandatory disclosure rules

Action 12 contains recommendations regarding the design of mandatory disclosure rules for aggressive tax planning schemes, taking into consideration the administrative costs for tax administrations and business and drawing on experiences of the increasing number of countries that have such rules.

Transfer pricing documentation and country-by-country reporting

Action 13 contains revised guidance on transfer pricing documentation, including the template for country-by-country reporting, to enhance transparency while taking into consideration compliance costs.

Making dispute resolution mechanisms more effective

Action 14 develops solutions to address obstacles that prevent countries from solving treaty-related disputes under MAP, via a minimum standard in this area as well as a number of best practices. It also includes arbitration as an option for willing countries.

Developing a multilateral instrument to modify bilateral tax treaties

Action 15 provides an analysis of the legal issues related to the development of a multilateral instrument to enable countries to streamline the implementation of the BEPS treaty measures, as well as the mandate to carry out that work in 2016.

Question 8

Is transfer pricing an anti-avoidance weapon? If so, why does it not have as a constituent element a requirement that the taxpayer have a tax avoidance purpose or motive. Purpose or motive only becomes relevant at the point of penalties which is odd if it is a driving factor.

Is it designed to stop tax cheats? In all the cases, are the taxpayers tax cheats? Is it not often the case that there is an adjustment just because there is a mispricing not because there is a deliberate attempt to cheat. Some cases could be looked at to consider whether the taxpayers in question were tax cheats.

Is it the only weapon available? What about general anti-avoidance rules, CFC type rules and thin capitalisation type rules? Double tax agreements especially business profits articles often deal with transfer pricing as well.

Does the existing case law suggest we are dealing with only the very worst cases of abuse? See Chevron and SNF as examples.

Question 9

The Parent company has provided something of value to the subsidiary in the form of the guarantee service. The parent should be compensated for the provision of this valuable service.

One might argue that the benefit is illusory or that it is of limited or little value. Depending on how it is provided it may be incapable of enforcement, e.g. if all that is provide is a non-binding Letter of Comfort that would suggest no real compensation should be provided.

Cogent evidence could be produced that in comparable arrangements there has been real consideration given in relation to the making of such guarantees. This would be instructive – see in particular GE Capital in Canada.

Either way documentation would be relevant to explain how the arm's length consideration was determined by the parties to the transaction.