Chartered Institute of Taxation
Excellence in Taxation

THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

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PAPER 3.03 – TRANSFER PRICING OPTION

Suggested Solutions

PART A

Question 1

Part 1

Step 1

Identify economically significant risks with specificity. Development risk including risks of failure.

Step 2

Contractual assumption of risk. Contractually Company X assumes the risk.

Step 3

Functional analysis in relation to risk. Company X controls the risk.

Step 4

Interpreting steps 1-3:

a) Whether the associated enterprises follow the contractual terms. Yes, Company X does control the risk consistent with contract.

b) Whether the party assuming risk, as analysed under (i), exercises control over the risk and has financial capacity to assume the risk. Yes, Company X in assuming the risk, does exercise control due to its expertise such as having the chief scientist and Company X being the company that hires Company Y, presumably is financially stronger than Company Y, thus would have the capacity to assume the risk.

Step 5

Allocation of risk. There is no question of allocation since the risk is aligned to people's function, control and the capacity to assume risk.

Step 6

Pricing of the transaction, taking account of risk allocation. Company X assumes and controls the risk and should be rewarded with the financial consequences of failure/success. Company Y should be appropriately rewarded for carrying out development services, incorporating the risk that it fails to do so competently

Part 2

The following changes apply:

Step 3

Company Y, not X controls the risk.

Step 4

a) Whether the associated enterprises follow the contractual terms. No, it is Company Y that controls the risk inconsistent with contract.

b) Whether the party assuming risk, as analysed under (i), exercises control over the risk and has financial capacity to assume the risk. No, Company X in assuming the risk, does not seem to exercise control due as the transfer of the chief scientist would bring with it the control to Company Y.

Step 5

Risk can no longer solely be allocated to Company X. Although Company X has the financial capacity to assume risks, Company Y now has the ability to control risk, thus must be allocated some risk.

Step 6

Company X assumes but does not control the risk and should be rewarded with a share but not all the financial consequences of failure/success. Company Y should be appropriately rewarded for carrying out development services and a share of the financial rewards for bearing the risk of failure/success as it exercises control over the risk.

Question 2

Part 1

This question is about making the connection between several parts of the OECD Guidelines, mostly Chapter VI (intangibles related questions) and Chapter IX business restructuring so the answer needs to make reference to both. It is not an easy question so the question tests if the candidate can make connections between different parts of the OECD Guidelines. It does not matter if the answer is not too precise in terms of exact references to the OECD Guidelines as the subject is covered in several sections, etc.

There are at least two relevant examples in the OECD guidelines that help us answer this question, Example 23 and 26 of the Intangibles chapter. Also parts of Chapter 9, Part II, compensation for the restructuring itself, in particular the section about transfer of something of value and going concern (Section D) and indemnification (Section E).

The answer needs to recognize that the €100M relates to business being bought and the existing TP policy, value drivers, functions, risks and assets needs to be taken into account. It is important that the answer recognizes that it is not only the specific legal assets that are being sold by the local legal entities.

The companies that have a profile as Limited Risk Distributor (LRD) will get a smaller share of the allocation. Nothing really changes for them except that they give away (to the third party) the Net Present Value (NPV) of their limited risk margin for the home care products. If the LRDs have any extraordinary costs related to selling that part of the business (such as laying off home care products sale people), in principle, they would need to be compensated for that.

For the stand alone companies, the situation is different because they arguably own some marketing intangibles related to the home care products (marketing intangibles, customer relationships, goodwill. These companies would therefore get a bigger share (than the LRDs) from the sales proceeds because they are basically selling off some of their intangibles to the third party and therefore need to be compensated from it (either directly from the third party or via Beauty HQ Co).

Similarly, for the manufacturing in France plus R&D it needs to be considered if any patents, intangibles, etc. are transferred to the third parties and what is the value. In France there will be also fixed assets and inventory transferred.

The company would also need to look at the intercompany agreements and see how they envisage the sale of a business (whether there would be compensation or not) and determine whether the intercompany agreements are arm’s length or not on those points. This needs to be taken into account in the allocation.

From the overall sales price there could be some parts that do not relate to any of the assets (tangible or intangible) being acquired (for example control premium).

In the reply it would also be important to refer to and explain briefly the concepts of goodwill (Chapter 6, Section A.4.6) and synergies (Chapter 1, D.8) as per the OECD Guidelines.

Part 2

The main risk is that the tax authorities in the countries would argue that something of value (an intangible asset, goodwill or a business opportunity) has been transferred to a third party and only one company (HQ Co) benefited from it. The result could be a transfer pricing adjustment (primary adjustment).

For the LRDs, the risks is probably small, especially if sales of beauty products increase as a result of a more focused sales strategy.

For the full-fledged distributors, which have made investments in the past in selling and promoting the homecare products, the risk is higher.

The highest risk is probably in France as they are transferring tangible and intangible assets and R&D related activities.

Risk management: there could be business reasons (Chapter 9, B.2) that justify no allocation, for example, the home care business had negative margins and the proceeds (or part of them) are going to be used to relaunch, from HQs, the beauty products; another approach would be to try to argue that the intercompany agreements can be cancelled without compensation (if that would be arm's length) (Chapter 9, E1 and E2); APA; another possibility would be to try to estimate the tax risk and book some tax provisions.

<u>Part 3</u>

The company may need to revisit its intercompany agreements. They will need to give consideration to the allocation of the proceeds given the existing transfer pricing policy and possible restructuring costs (redundancies, adjusting business strategy, etc). Also the company will continue to buy some lavender products (now from a third party) so this could be a CUP (either for the TPs applied in France in the past or for those applied in Mexico for aloe vera. Need to mention briefly the comparability question: is the transaction Homeco selling lavander to HQ comparable to the transaction in which M Co selling aloe vera to HQ Co? Probably not.

PART B

Question 3

Part 1

Candidates should identify up to 5 differences out of the following:

- the simplified approach is elective to the taxpayer;
- only applicable to defined category of intra-group services;
- agreement on categories of costs to be included in cost base;
- a mark-up of 5% is deemed appropriate for such services;
- the benefits test is simplified and moderated;
- consistent allocation key; and
- greater transparency in reporting, with documentation showing working of the specific cost pool.

Part 2

Candidates should be to apply the ALP to one or more of the above observations in (1) and explain why this elective simplified approach departs from the ALP which advocates that services transactions regardless of whether they are high or low value added, should be compared to what independent parties transacting at arm's length should have conducted themselves. There is no consideration of what independent parties would have done. The mark-up and benefits test are also fixed or modified instead of the full enquiry into whether independent parties would have accepted the 5% mark-up or benefitted such as to procure the service instead of performing it themselves or sourced from a third party. There is also the assumption businesses are only willing to incur costs if there is a business reason to do so which is not part of the ALP comparability approach.

Part 3

Candidates should be able to name and explain up to 5 benefit or disadvantage out of the following:

- Benefit: simplified tax administration, allowing limited audit resources to be redirected to other more serious BEPS issues;

- Benefit: equal and consistent treatment of the same types or categories of services;

- Benefit to taxpayers as this approach is elective;

- Disadvantage: Giving taxpayers an option to elect risks abuse or at the least inconsistency;

- Disadvantage: developing or poor countries would be capped at 5% of mark-up; and

- The ability for tax administrations to include a threshold above which the simplified approach may be denied. Further work on the threshold will be performed as part of step two in 2018.

Part 4

Candidates should be able to explain location savings. "Location savings" refers to the cost savings derived by a multinational enterprise, usually from the relocation of operations to a low-cost jurisdiction. Location savings has gained increased attention in recent years as revenue authorities in developing countries (such as India and China) are insisting that the economic benefits arising from the relocation of operations to a low-cost jurisdiction should accrue to that country.

Candidates should then go on to explain that countries advocating location savings are likely to point to such savings and seek greater remuneration than accept that such services are low value adding and that the mark-up should be limited to 5%.

Question 4

Part 1

The answer needs to provide a brief summary (commensurate with the weight of the question: 3-4 paragraphs) of the case.

GE Canada issues debt in the market with GE US guarantee. GE Canada pays a fee of 100 bps to GE US for the guarantee.

CRA argues the guarantee is just a paper which was not needed and has no value as GE Canada, as member of the group, would have been able to issue the debt with same T&C.

Expert witness uses several methods to show that without the guarantee the T&C would have been different. The method accepted by the court looks at the stand alone credit score of GE Canada.

Supreme Court agrees with the approach of the expert witness/taxpayer but acknowledged that the value of implicit support needs to be considered and cannot be charged for. So the stand alone credit score needs to be adjusted up towards the credit rating of the parent. The difficulty is that there is not a clear methodology on how to apply the arm's length principle and at the same time take into account the concept of implicit support or passive association.

Part 2

The answer needs to mention that the concept of incidental benefits and group synergies and central purchasing are discussed in different parts of the guidelines. Some parts address it more generally (Chapter 7, Services) some more detail (Chapter 1, comparability factors).

The OECD Guidelines make specific reference to incidental benefits in Chapter 7, Services, in the context of allocating cost for the provision of services. (7.12 and 7.13). If an activity is taking place in a group that provides only an "incidental" benefit to some of the group subsidiaries, the group subsidiaries do not need to pay for that incidental benefit. There is an example about a subsidiary having a higher credit rating.

The OECD Guidelines refer in the new Chapter 1 more extensively to this concept. Chapter 1 D8. They consider this a comparability factor.

The OECD guidelines make a difference between synergies that arise from deliberate concerted action (like in the example of a central purchasing scenario) and synergies/costs that arise from passive association. It is not clear however what this passive association benefits or costs could be and how they could be measured so the OECD Guidelines concentrate on the easier example of credit rating (as in the GE Case) and central purchasing that are more clear cut examples. The BEPS action 8, 9 and 10 deliverable mention that the OECD will be working on this point during 2016 and 2017.

PART C

Question 5

Part 1

Candidates should identify and briefly explain the one related party transaction identified out of each of the following periods:

- 2007-2010: Marketing services provided by the DMG marketing office in India to DMG or on behalf of DMG to Titan. On the facts, this marketing office can be a separate legal entity or a PE. The 35% stake acquired in 2009 does not in general render Titan a related party under the OECD principles though it may under Indian transfer pricing rules.

- 2010 – end of 2012: Distribution services or arrangement between Titan and TD to distribute MicronA to German car dealers.

- (2013 onwards: By DMG holding 51% in Titan, Titan and by extension TD becomes related parties to DMG and DMG's marketing office in India. One related party transaction is the limited risk distribution agreement between DMG and Titan to distribute cars in India. A second related party transaction is the use of DMG's patents by Titan, notwithstanding no charging a royalty or fee is likely not arm's length. The transfer of production line from DMG to Titan is another related party transaction. Other related party transactions include the loan and head-office services provided by DMG to Titan.

Part 2

Candidates may answer based on either each type of transaction, or by the collective functions, assets and risks of each entity

Titan

Functions: Manufacturing of Micron A and other cars based on production line transferred. Distribution in India.

Tangible assets: Factory including assembly line transferred. Showroom for distributing DMG cars

Intangible assets: Titan brand, customer list.

Risks: Market, credit and inventory risk from the limited risk distribution by TD.

DMG

Functions: Manufacturing. Treasury function. Head-office support services, including finance and marketing.

Tangible assets; factory, offices of HQ. Capital against the loan.

Intangible assets: DMG brand/marketing intangibles, Patents.

Risks: Market, credit and inventory risk from the limited risk distribution by Titan. Credit and potentially interest rate and currency risk from loan to Titan.

TD

Functions: Distribution. Marketing.

Tangible assets: office, showroom.

Intangible assets: custom list in Germany.

Risks: Credit risk from German car dealers unless they pay upfront.

Question 6

This is a standard question that can be answered directly from Chapter 2, Part III, B.

The transactional net margin method is one of the transactional profit methods. The method compares net profits relative to an appropriate base.

The OECD Guidelines give a few examples of the pros and cons of applying the TNMM. They also explain what are the profit level indicators that could be used with the TNMM.

Net profit is weighted to sales. This is usually used to determine the arm's length price of purchases from associated enterprises that resale to independent customers. The sales revenue that is derived from uncontrolled transactions should not be included in the calculation.
Net profit weighted to costs. This used when costs are the relevant indicator of the value of the functions performed. In most cases costs relates to operating costs only.

Net profit weighted to assets. An example is return on assets or return on capital. This is used for certain manufacturing or asset intensive activities.

Berry ratios. This section of the OECD guidelines refers also to other net profit ratios (for example weighted to retail points, headcount or others) and the berry ratio. The berry ratio is defined as gross profit to operating expenses. Berry ratios can be useful for intermediary activities where a taxpayer purchases goods from an associated enterprise and sells them to another associated enterprise.

Question 7

Part 1

A compensating adjustment is an adjustment in which the taxpayer reports a transfer price for tax purposes that is, in the taxpayer's opinion, an arm's length price for a controlled transaction, even though this price differs from the amount actually charged between associated enterprises. This adjustments are generally made before the tax return is filed.

Part 2

The OECD Guidelines recognize (Chapter 1, section D.5) that the methods used for customs valuation and transfer pricing purposes can be different and that taxpayers can have competing incentives in setting values for customs and tax purposes. If a transfer pricing compensating adjustment is made that decreases the profitability of an entity (to bring it within the interquartile range), the customs value of the goods related to that specific transaction may need to be reviewed. The OECD Guidelines (Chapter 1 Section D.4) also recognize that certain government policies for example foreign exchange controls could also make it difficult to implement transfer pricing policies.

Part 3

In both cases the OECD Guidelines invokes the customs and tax/transfer pricing authorities to cooperate. With respect to other government policies the OECD also proposes countries to cooperate to avoid double taxation or to avoid policies that are inconsistent. From a practical point of view companies can try to put in place policies to circumvent these limitations: for example using the interquartile range to try to avoid compensating adjustments, or using conservative budget figures to try to limit the adjustments or that the adjustments would be an additional payment to the subsidiary instead of a payment form the subsidiary.

Question 8

Part 1

An advance pricing arrangement (“APA”) is an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (e.g. method, comparables and appropriate adjustments thereto, critical assumptions as to future events) for the determination of the transfer pricing for those transactions over a fixed period of time (Para 4.123, OECD TP Guidelines).

The mutual agreement procedure is a well-established means through which tax administrations consult to resolve disputes regarding the application of double tax conventions. This procedure, described and authorised by Article 25 of the OECD Model Tax Convention, can be used to eliminate double taxation that could arise from a transfer pricing adjustment. (Para 4.29, OECD TP Guidelines).

Candidates should be able to point out that the MAP is generally invoked when there is already a transfer pricing dispute and the purpose is to eliminate double taxation through the use of a Double Tax Treaty such as corresponding adjustment under Article 9(2) whereas an APA is generally invoked in advance of any dispute or transfer pricing adjustment to determine the transfer pricing for transactions over a number of years (though with roll-backs this can cover open years as well).

Part 2

For MAPs, the treaty needs to contain Article 25 as set out in the OECD Model Tax Convention. Article 25 sets out three different areas where mutual agreement procedures are generally used. The first area includes instances of “taxation not in accordance with the provisions of the Convention” and is covered in paragraphs 1 and 2 of the Article. Procedures in this area are typically initiated by the taxpayer. The other two areas, which do not necessarily involve the taxpayer, are dealt with in paragraph 3 and involve questions of “interpretation or application of the Convention” and the elimination of double taxation in cases not otherwise provided for in the Convention. Paragraph 9 of the Commentary on Article 25 makes clear that Article 25 is intended to be used by competent authorities in resolving not only problems of juridical double taxation but also those of economic double taxation arising from transfer pricing adjustments made pursuant to paragraph 1 of Article 9.

Specific to transfer pricing, certain countries (though the OECD disagrees), require Article 9(2) to be present in the treaties before disputes leading to double taxation can be resolved. A corresponding adjustment in Article 9(2) which the OECD states that in practice may be undertaken as part of the mutual agreement procedure, can mitigate or eliminate double taxation in cases where one tax administration increases a company’s taxable profits (i.e. makes a primary adjustment) as a result of applying the arm’s length principle to transactions involving an associated enterprise in a second tax jurisdiction.

For APAs, the OECD TP Guidelines in Para 4.139 states that APAs involving the competent authority of a treaty partner should be considered within the scope of the mutual agreement procedure under Article 25 of the OECD Model Tax Convention, even though such arrangements are not expressly mentioned there. Paragraph 3 of that Article provides that the competent authorities shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention.

Part 3

Candidates should describe up to 4 benefits and problems in regard to a MAP. These include, but are not limited to, the issues discussed in BEPS Action 14:

- The BEPS Action 14 recommends that countries provide access to MAP in transfer pricing cases and should implement the resulting mutual agreements, including corresponding adjustment even in the absence of Article 9(2).

- Countries should provide MAP access in cases in which there is a disagreement between the taxpayer and the tax authorities making the adjustment as to whether the conditions for the application of a treaty anti-abuse provision have been met or as to whether the application of a domestic law anti-abuse provision is in conflict with the provisions of a treaty.

- Countries should commit to a timely resolution of MAP cases: Countries commit to seek to resolve MAP cases within an average timeframe of 24 months.

- Countries should publish rules, guidelines and procedures to access and use the MAP and take appropriate measures to make such information available to taxpayers.

- Countries should ensure that the staff in charge of MAP processes have the authority to resolve MAP cases in accordance with the terms of the applicable tax treaty, in particular without being dependent on the approval or the direction of the tax administration personnel who made the adjustments at issue or being influenced by considerations of the policy that the country would like to see reflected in future amendments to the treaty.

- Countries should clarify in their MAP guidance that audit settlements between tax authorities and taxpayers do not preclude access to MAP. If countries have an administrative or statutory dispute settlement/resolution process independent from the audit and examination functions and that can only be accessed through a request by the taxpayer, countries may limit access to the MAP with respect to the matters resolved through that process.

Other benefits and problems include:

- Taxpayers lose control in an MAP process compared to APA because once started, the process generally proceeds between the Competent Authorities.

- MAPs may be cost effective as Competent Authorities generally do not charge expensive fees to resolve disputes for taxpayers. However, the advisor fees may be substantial if there is no resolution over the years.

- There is often no suspension of the collection of outstanding tax related to adjustment in question by a tax jurisdiction during MAP proceedings (e.g. tied up cash).

Question 9

Part 1

This can be taken directly from the Guidelines Chapter 1, D1.1.1 to D1.5. These sections have become really long but the key points are the same than in the former Guidelines so it can be answered with any of the two sources (Chapter 1 as in the 2010 Guidelines or Chapter 1 as in the 2015 Guidelines).

The five comparability factors are:

- Contractual terms of a transaction. The written contract agreements provide the starting point for the comparability analysis.

- Characteristics of products and services: for example is the product branded or unbranded, is the product bulk or retail, is the service highly specialised (perhaps utilising protected proprietary IP) or more basic, etc.

- Functional analysis. A good functional analysis is the cornerstone of a good transfer pricing study. As this functional analysis was often underestimated the new OECD Guidelines has updated this part of the guidance. In essence a functional analysis is a method of finding and organising in-depth facts surrounding an intracompany transaction, including identification of the relevant functions, risks and assets affecting the pricing of the transaction. It needs to be performed relative to the other party in the intercompany transaction and relative to the whole group. Often, functional analysis includes interviews with key personnel within the company to gather data.

- Economic circumstances: Economic circumstances refers broadly to the local market circumstances that affect the relevant intercompany transaction. For example, what is the level of government intervention in the market? Is there a lot of competition in that market segment or only a few players? What are the local costs of production, access to natural resources, access to consumers? Economic circumstances is a very broad but very relevant comparability factor that is often underestimated in practice.

- Business strategies: this refers to the overall strategy of the group (e.g. innovation driven, risk adverse, market leader, follower, price leader, quality focus) and the specific strategy of the relevant legal entity: start-up company, defensive strategy, exiting gradually, competing in home market versus new markets. It is more difficult to use business strategy as comparability factor because it can be very specific to a particular company with not many comparables available so in a comparability analysis you would look at business strategy in a broader sense.

Part 2

If the company has a transaction with a third party that could be comparable to a transaction intercompany the five factors mentioned above need to me check one by one to compare one transaction with the other one. For an internal CUP analysis it should be relatively easy to apply each factor (compare third party contract with intercompany contract, compare product characteristics, compare functions, risk and assets of each party to the transaction –arguably there could be less information about the third party.

The case from the reader is SNF Australia. SNF Australia has been making losses for a number of years and ATO challenges the TP method applied (CUP method) and argues for the use of the TNMM. SNF France sells bulk chemicals to Australia and to third parties in other countries. The expert witness analysis a number of agreements with third parties (volume, quality of the product, pricing) and concludes that the prices are arm’s length.